FLASH REPORT

ON KEY ECONOMIC AND FINANCIAL
DEVELOPMENTS
BASED ON 2005 DATA

Main Indicators of the Hungarian Economy

2003 - 2006

	2003	2004	2005		2006
	fact	preliminary fact	(Oct. 2005)	(Jan. 2006)	projection
					annual percentage change at constant prices
Gross Domestic Product	3.4	4.6	3.5 - 4	cca. 4.2	4.2 - 4.5
Domestic use of GDP	6.2	2.8	2 - 3	2.5 - 3	cca. 4
of which:household consumption	7.8	3.1	cca. 3	cca. 3	cca. 3.5
gross fixed capital formation	2.5	8.4	6 - 8	7 - 8	7 - 8
Foreign trade turnover (goods and services)					
Exports	7.8	16.4	9 - 11	9 - 11	10 - 12
Imports	11.1	13.2	7 - 9	6 - 8	10 - 12
					annual percentage change
Gross average wages	12.0	8.2*	6 - 8	8 - 9	cca. 5
Net average wages	14.3	7.1*	8 - 10	9 - 10	cca. 6
Real wages, per employees	9.2	0.3*	4 - 6	5 - 6	cca. 4
Number of employees	1.3	-0.5	0 - 0.5	0 - 0.2	0 - 0.5
Unemployment rate (ILO), %	5.9	6.1	6.8 - 7	7 - 7.3	cca. 7
Consumer price index (annual average)	4.7	6.8	3.5 - 4	cca. 3.6	cca. 2
					at current prices
Foreign trade deficit, Euro billion	4.2	3.9	3.3 - 3.5	2.9 - 3.1	3 - 3.5
Current account deficit, Euro billion	6.4	7.1	7.1 - 7.3	6.7 - 7	6.9 - 7.2
					in percentage of GDP
ESA95 general government deficit**	6.5	5.4	6.1	6.1	4.7
Current account deficit	8.8	8.8	8.1 - 8.4	7.6 - 8	7.5 - 7.8

*/ In public sector corrected with the regulation change of additional one month salary

**/ With the effect of pension reform

Introduction

In 2005 the Hungarian economy grew by above 4 % maintaining its export and investment-led growth structure. This growth performance was supported mainly by the slower than expected but gradual external economic recovery witnessed in H2 2005. In addition to the expansion of Hungarian exports into the main markets (EU-25), the above-average increase of exports outside the EU also contributed to the fast, export-driven economic growth. Reflecting the improving economic conditions, investment growth has been accelerating since Q4 2004 with sound structure. Even though the volume of manufacturing investments declined in Q3 2005 (compared to the corresponding period of the previous year), it is partly attributable to the base effect and, as indicated by capacity utilization figures, appears to be a temporary phenomenon.

The trade balance improved significantly, in excess of the rate indicated in the previous forecast, due to favourable export growth and also the slow-down of import growth caused mostly by one-off factors. The trade deficit for the entire year is expected to be EUR 0.8-1 billion lower than in 2004, therefore the current account balance to GDP ratio is expected to improve more than indicated in the previous forecast, while the inflow of EU transfers will result in an even greater drop in the external financing requirement.

Monetary conditions eased in 2005, reflecting, inter alia, the effects of the base rate cuts implemented up to September, but nominal interest rates are still higher than in neighbouring countries. The accrual-based (ESA95) general government deficit figures changed primarily due to methodological reasons, but they developed in line with the forecast revised in September. The cash balance, also reflecting the measures taken during the year to assure compliance with the deficit target, turned out to be slightly better than originally projected.

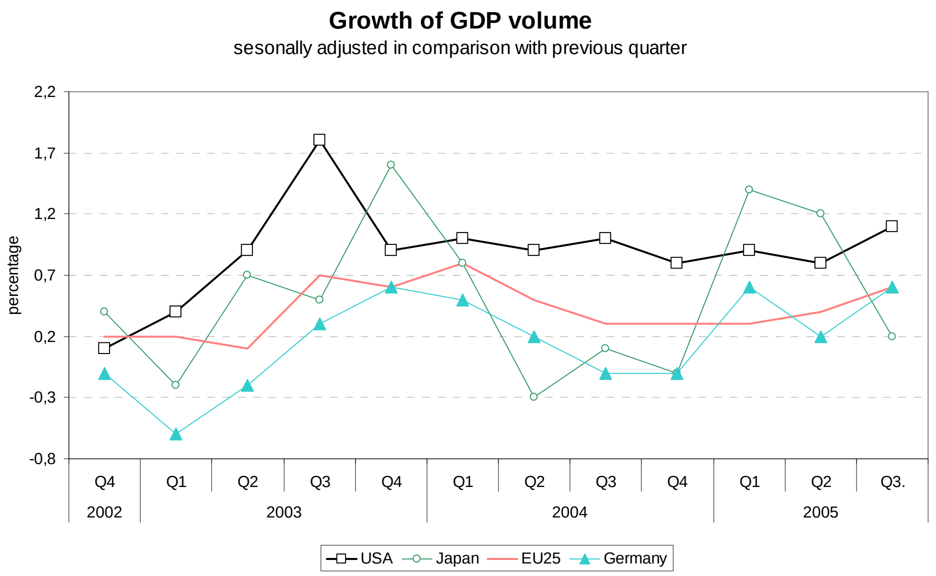
In 2005, the inflation rate followed a declining trend. The annual average 3.6% increase of consumer prices has been the lowest in thirty-one years. The disinflationary effects proved to be stronger than the inflationary pressures exerted by energy prices. As a highly favourable sign for the medium-term outlook, the core inflation indicator sank below 2% after mid-year.

According to the forecast for 2006, the relatively fast economic growth in a sound structure will be maintained. External balance will continue to improve, the ESA95 general government deficit will decline to 4,7% of GDP following a temporary rise in 2005. Partly as a result of the VAT rate cut effective as of 1 January, the annual average consumer price increase may be around 2%.

1. External economic environment

The improvement of the global economic climate started in the second half of 2005…

After a more modest growth rate in the first half of 2005, the global economy started recovering its dynamism in the second half-year. In the whole of 2005 and also in Q3, the driving force of growth continued to be the United States (4.3%) and the Asian countries (except for Japan), in particular China (9.4%). During the year, the continuously high oil prices presented a risk for the GDP growth of the US; nevertheless, consumption growth remained robust. Based on the short-term outlook, the dynamic growth of the United States will continue, and the Asian countries (apart from Japan) are expected to maintain their current good performance with accelerating exports.

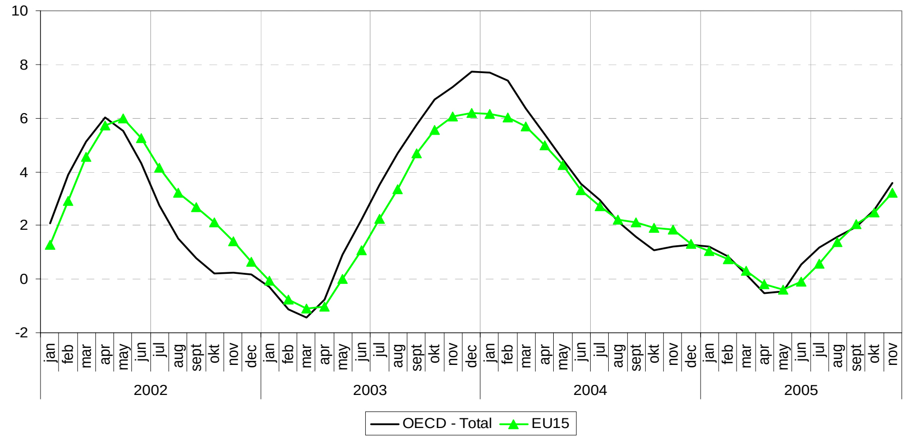


…may continue in 2006

Growth indicators project the continuation of the improving trend started in the second half of 2005. The Composite Leading Indicator of the OECD[1], which is used to forecast the turning points in business cycles, increased each month between July and November both for the entire OECD and for the EU-15. Thus the indicator forecasts stable improvement in the external economic environment for early 2006.

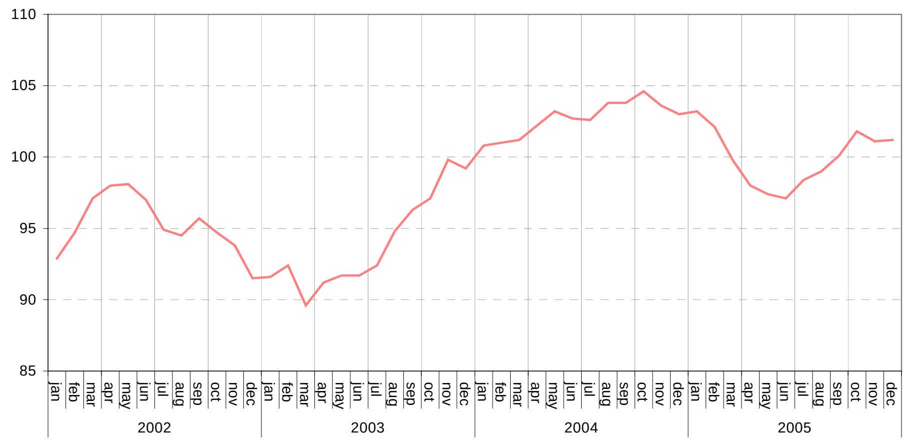
[1] OECD Composite Leading Indicator (CLI), 2006. január 6.

OECD Composite Leading Indicator
6-month rate of change at annual rate



Last year, growth increased in the European Union (EU25) gradually, quarter by quarter, GDP rising by 1.9% in Q3. In the whole of 2005, a 1.3% growth of GDP is projected in the Euro area and 1.5% in the European Union. The slow improvement was promoted by the pickup of consumption and investments alike. Following on the approx. 6% devaluation of the euro since the beginning of the year, the robust export growth started in Q2 and Q3 is expected to continue early in 2006. The composite business and consumer confidence index (ESI) for the EU has been improving since the summer of 2005, which indicates that the economic actors consider the outlook to be improving. The business sector is especially optimistic in the field of manufacturing and retail trade, and increased consumer confidence promises continued consumption growth.

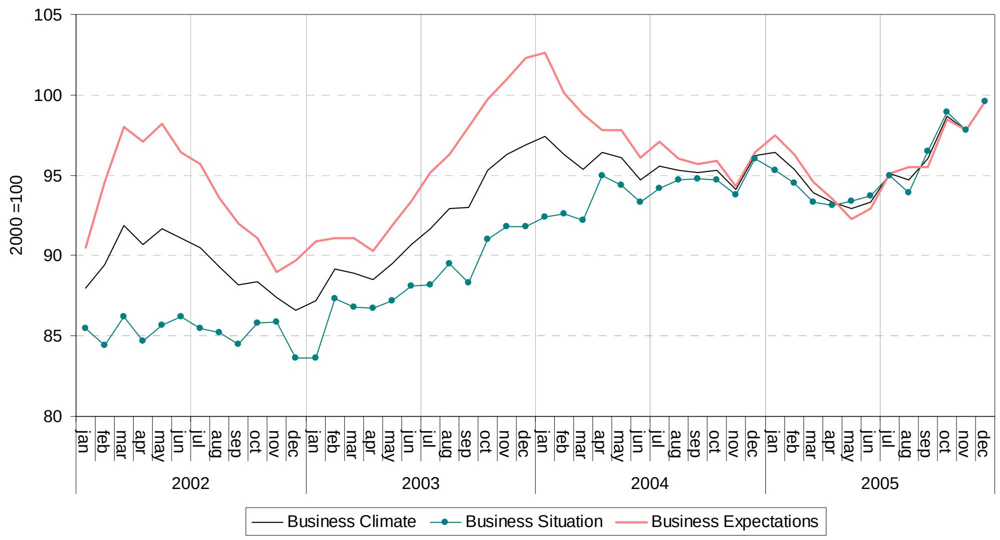
EU25 Economic sentiment indicator
(seasonally adjusted, average=100)



Continuously improving German growth prospects

In the German economy, the first half of 2005 was characterised by deteriorating expectations, which trend was reversed in May and, except for one setback in November, improved continuously. The IFO index for Germany rose from the low of 92.9% in May to 99.6% at the end of the year. Parallel with the increase of confidence, GDP growth also strengthened in Q3.

IFO Business climate for Germany



Dynamic growth in new Member States

Of the Visegrád countries, the annualised growth rate in Q3 was 4.9% in the Czech Republic and 4.5% in Hungary, while GDP growth in Poland in the same period was more modest at 3.7%. The robust growth of the Members States outside the Euro area is expected to continue in 2006.

Fewer risks in 2006

In the whole of 2005, high oil prices and global current account imbalances presented the main risks for the global economic environment. Despite high oil prices, consumption and investment growth showed hardly any decline in the main oil importing countries. The global current account imbalances present uncertainties in the medium term, therefore they are given major emphasis in the year 2006 forecasts. On the whole, the growth forecasts for the global economy, the Unites States and the Euro area contain less uncertainty for the forthcoming quarter than in the previous quarters.

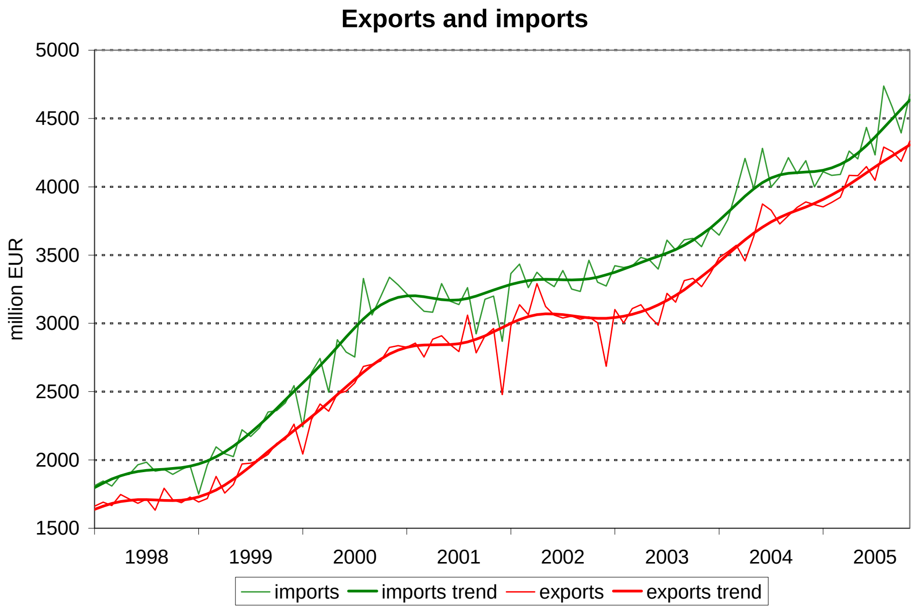
2. Growth factors

2.1 Foreign trade and competitiveness

2.1.1 Foreign trade of goods

Exports accelerating in excess of imports since early 2005 …

The growth of exports and imports, which had been declining as from the second half of 2004 as a result of the sluggish external expansion, started accelerating in February 2005. Following a slow-down in Q4 2004 (0.7%), the monthly growth rate of exports increased to 0.9% in the first half-year and has been 1.0% since May. Imports showed a more dynamic increase, monthly growth rates increasing from the low level of 0.2% in Q4 2004 to 0.7% in the first half-year and to 1.4% in Q3; the monthly import growth has been 1.5% since August.



Between January and November 2005, the volume of exports increased by approx. 10% (based on estimated price indices). The modest (6.7%) growth in Q1 was followed by significant expansion in Q2 and Q3, by 12.6% and approx. 11%, respectively, in volume terms. In November the volume of exports increased by approx. 12.5%, a rate similar to that seen in the second quarter. After a low growth rate in the first half-year (2.9%), import volumes rose by 7% in Q3 and by approx. 10% in November. On the whole, imports went up by about 5% in the firsts eleven months of the year. In Euro terms, exports increased by 10.9% in January-November and by 12.4% in November over the corresponding periods of 2004. The value indices of imports were considerably higher than volume indices due to rising crude oil prices; the growth of imports in euro terms amounted to 7.5% in the first eleven months and to 12.2% in November.

…resulting in a lower trade deficit

The trade deficit dropped significantly in the first six months, then it essentially maintained the level of the base period in July-November; the deficit amounted to EUR 2.5 billion in the first eleven months, EUR 1.1 billion less than in the base period.

Detailed statistical figures by product and country are available for the first ten months; the structural and country-group export and import assessment below is based on those figures.

Significant growth in the exportation of machinery, energy and cereals,…

In volume terms, exports increased by 9.7%, imports by 4.2% in January-October 2005. The commodity structure of exports was dominated by the above-average growth of the exportation of machinery (almost 9%), but every sector increased its exports substantially with the only exception of communications technology. Machinery exportation growth was driven by the exports of energy generation equipment, office machinery and data processing equipment, road vehicles (engines) and electric machinery. The approx. 9% volume growth of manufacturing was attributable primarily to the expansion of the exportation of pharmaceuticals and plastics. The exports of fuels (crude oil products) and of food products (cereals) produced the most dynamic growth (26% and 10%, respectively, in volume terms).

…as well as in the importation of machinery for re-exportation and of crude oil…

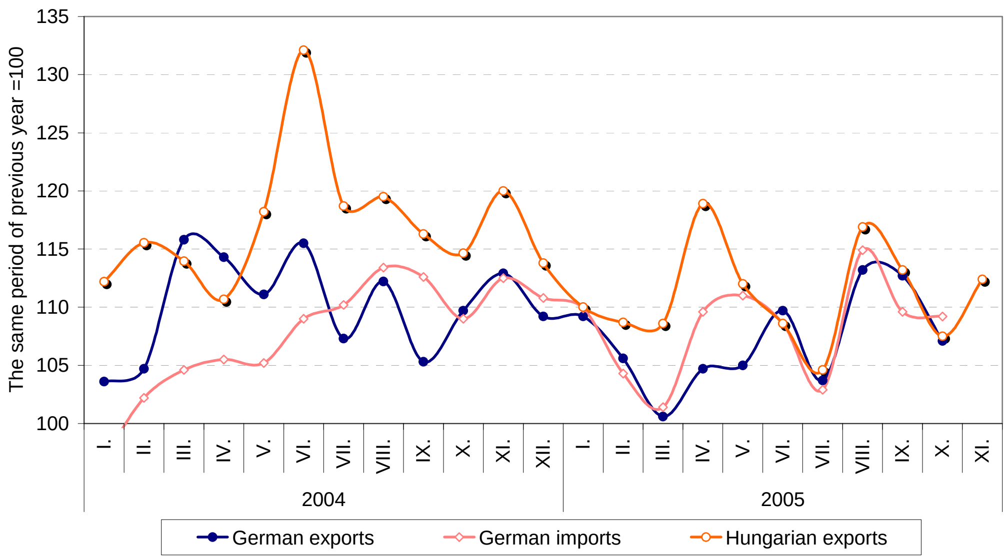
The commodity structure of imports was also dominated by machinery importation, its approx. 4.5% growth originating primarily in the importation of machinery and components from non-EU countries for re-exportation and in machinery imports for investment purposes (energy generation equipment, specialised machinery). The importation of food products showed a significant growth (at 10%), such imports from Member States increased by 17%.

…while the terms of trade worsened continuously

The terms of trade for Hungary worsened by 1.7% due to the rising fuel prices, causing a price loss of almost EUR 740 million. The terms of trade worsened by only 1.2% in the first half-year, while in Q3 its deterioration came close to 3%, and the rate was similar in October.

In terms of country groups, the volume of exports to the European Union increased by almost 6%; exports to the EU15 remained flat during the first seven months, then rose sharply, producing a 2% volume growth in the January-October period. Export trends show a close correlation with the export trends of EU Member States, in particular Germany (supplier activities).

German foreign trade and Hungarian exports of goods



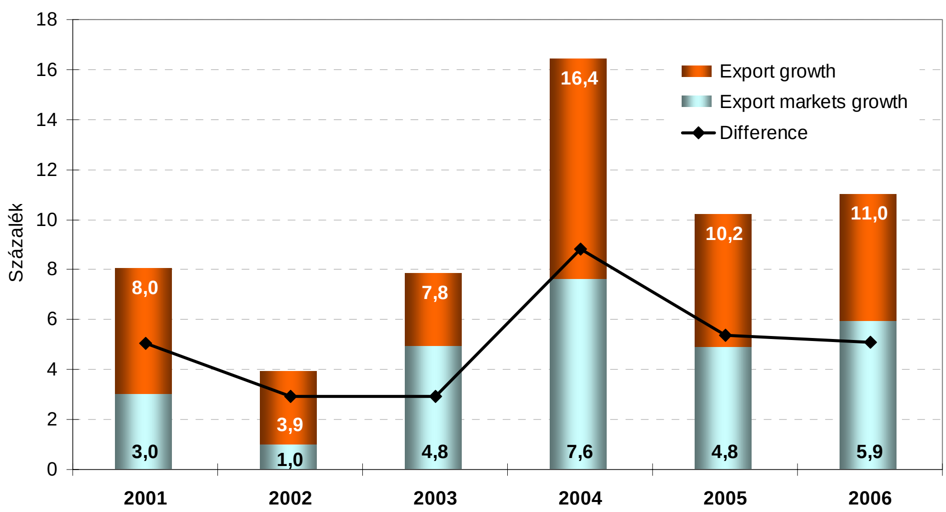
Intensive expansion of exports continued into new Member States and non-EU countries within Europe

Exports into new Member States have been increasing continuously at a rate significantly above the average since 2003 (by 25-30% in volume terms). That trend continued until October 2005, the volume of exports growing by 37%. In respect of countries outside the European Union, the volume of both exports and imports increased at rates exceeding the average: by 26 % and 16 %, respectively. Exportation into extra-EU countries in Europe (Russia, Romania, Croatia, Bulgaria, Turkey) increased by 32 % in euro terms. The importation for export purposes from Asian countries (Japan, China, Hong Kong) increased by over 29 % in euro terms. As a result, the commodity trade became more diversified, the share of EU15 countries falling from 71% of exports to 66%, and from 63% of imports to 58% as compared to the base period.

Based on the January-November export and import growth it is highly probable that the volume growth of exports in 2005 will be within the forecasted 9-11% band, while the import growth will be below the lower edge of the 7-9% band. The expected lower import volume growth of around 6% is attributable to the higher-than-projected manufacturing and energy prices; the deterioration of the terms of trade may come close to 2%, resulting in a price loss of EUR 0.9-1 billion. The trade deficit is expected to be about EUR 2.9-3.1 billion, which corresponds to a drop of EUR 0.8-1.0 billion.

In the short term, the economic expansion of the European Union as experienced in the second half of 2005 and expected for the beginning of 2006 is likely to step up demand on Hungary's export markets in 2006[2]. However, the growth of Hungarian exports has exceeded the expansion of the export markets for years, which has been reinforced by the diversification of the export structure in recent years.

The growth rate of exports and export markets



In 2006, a 10-12 % volume growth of exports is expected. As a result of the expansion of domestic demand, in particular of corporate investments with high import requirement, and the significant export growth, import growth is expected to approximate that of exports. The trade deficit is projected to be between EUR 3-3.5 billion.

2.1.2 Competitiveness

On the whole, the surveys of various international institutes indicate that the competitiveness position of Hungary has improved in 2005 over the year 2004 level, and returned to the level disclosed in the publications for the year 2002,

According to surveys of international

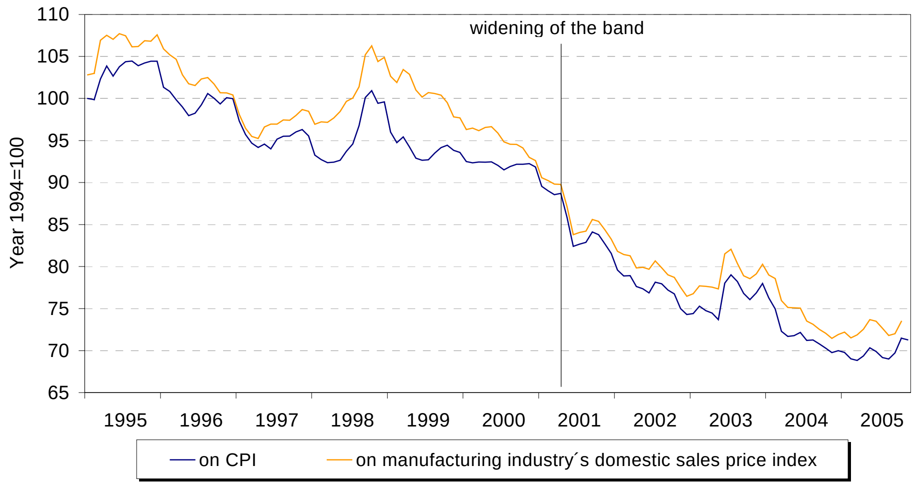
[2] For determining the demand on Hungary's export markets, the import demand of the 10 developed countries most important for Hungarian exports and Hungary's 5 major Eastern European partners are taken into account.

which, taking into consideration the delayed availability of data as well, effectively means the regaining of competitiveness position achieved in the years 2000-2001. Because of the structural characteristics of the economy (manufacturing exports represent approx. 90% of total exportation, there are a number of multinationals operating in manufacturing), the price and cost-based real effective exchange rate indices have a limited potential to show the competitiveness of the Hungarian economy. Those indices show a real appreciation, albeit at a rate decelerating during last year.

institutes, competitiveness position has improved; real appreciation has slowed down

Real appreciation of around 3% (on a year-on-year-basis) occurred both on a CPI basis in the first eleven months of 2005 and on a manufacturing PPI basis in the first ten months. The price-based real appreciation trend significantly decelerated during the year; indeed, in October and November a 2% real depreciation was recorded on a year-on-year basis due to the favourable inflation trend and the slightly weakening exchange rate. Because of the significant decline in the inflation differential to Hungary's main trading partners, the CPI-based real appreciation is expected to be only slightly higher in 2005, as the annual average, than the 1-2% level that can be sustainable in the case of the fast-growing converging economies.

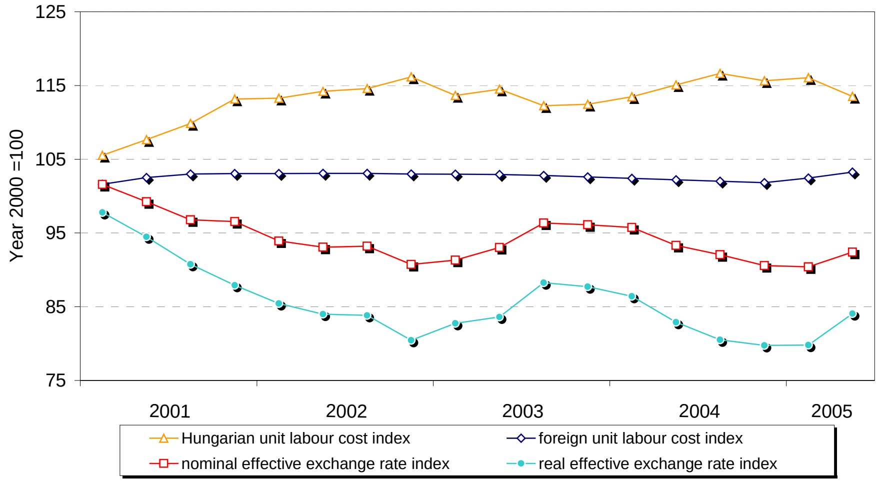
Real effective exchange rate index based on prices
(seasonally non-adjusted monthly data, estimation, values over 100 mean real depreciation)



In recent years, real appreciation was driven, apart from nominal exchange rates, by the wage increases being substantially higher than the moderate productivity growth. In this respect a favourable turn occurred recently, labour costs and productivity growing increasingly in line.

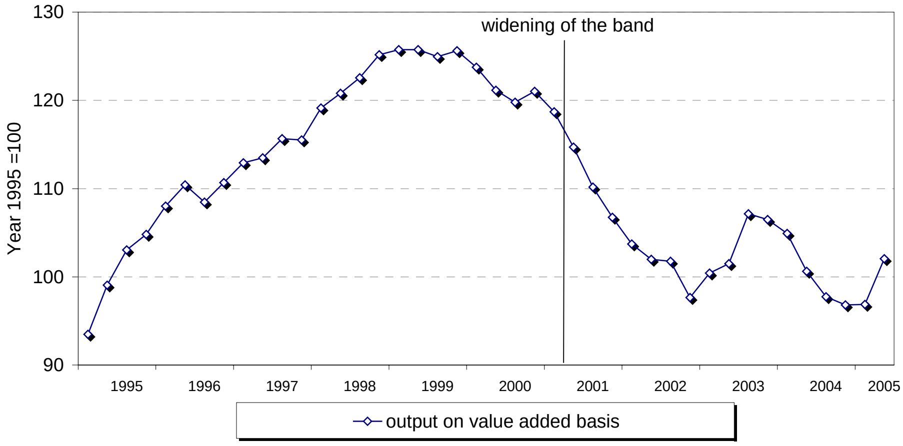
The growth of labour costs and of productivity increasingly in line

Real effective exchange rate index based on unit labour cost of manufacturing industry
(seasonally adjusted quarterly data, values over 100 mean depreciation)



In the case of a small, open, fast-growing economy, the development of cost competitiveness plays a far more important role than price competitiveness. However, cost-based competitiveness data are available only for the first half of 2005 at this point. Even though the average of the first half of 2005 shows an approx. 3% real appreciation over the corresponding period of 2004, the trend is favourable because the significant, almost 8% real appreciation of Q1 was followed by an approx. 1.5% real depreciation and competitiveness improvement in Q2.

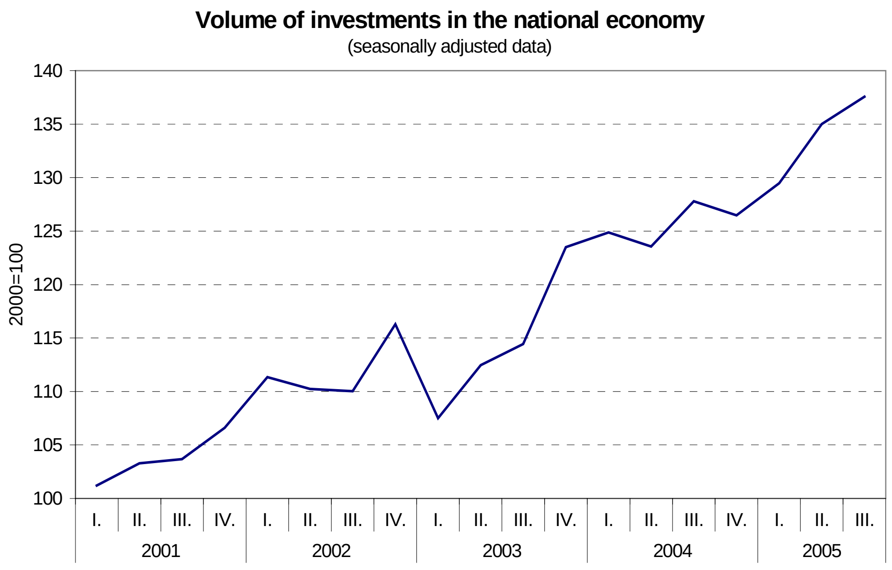
Real effective exchange rate index based on unit labour cost of manufacturing industry
(seasonally adjusted quarterly data, estimation, values over 100 mean real depreciation)



2.2 Investment

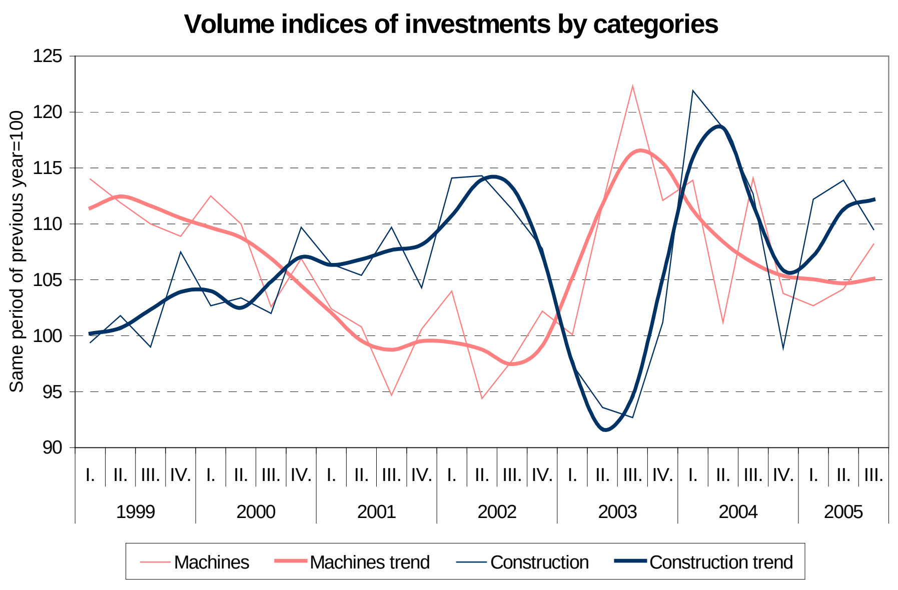
Robust investment growth…

The volume of investment in the national economy increased by an outstanding 8.7% in Q3, and by 8.5% in the first nine months. Since the last quarter of 2004, the investment dynamics has remained unbroken and has accelerated quarter by quarter.



The structure of investments has shown an improving trend quarter by quarter. Although construction investments continue to dominate because of the high-volume motorway construction projects, the growth rate of investments in machinery has accelerated gradually and in Q3 both produced a similar growth rate (construction: 9.5%, machinery: 8.2%).

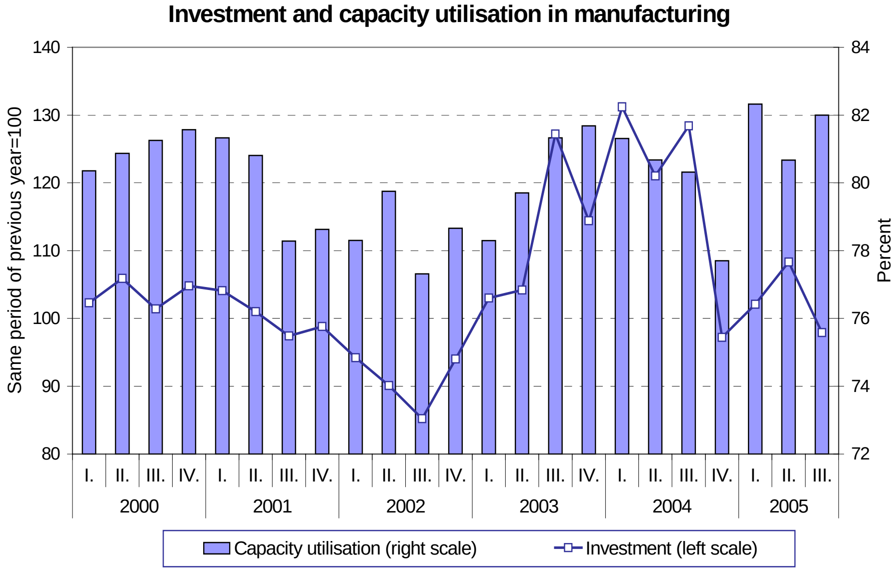
… in a gradually improving structure



As an unfavourable development, the volume of manufacturing investments declined by 2.1% in Q3; this, however, was partly due to the fact that the rate of growth of such investments was outstandingly high (28.4%) in the corresponding period of the previous year. The most recent capacity utilisation figures indicate that this drop in manufacturing was temporary. Ever since the autumn of 2003 - apart from a decline in the last quarter of 2004 - the capacity utilisation in the manufacturing sector has fluctuated between the high values of 80-82%. In Q3, capacity utilisation was substantially higher-than-average in the machine industry (85%), which has a large weight; this may have a positive

Temporary slow-down in manufacturing

effect on the investment trend in the forthcoming quarters.



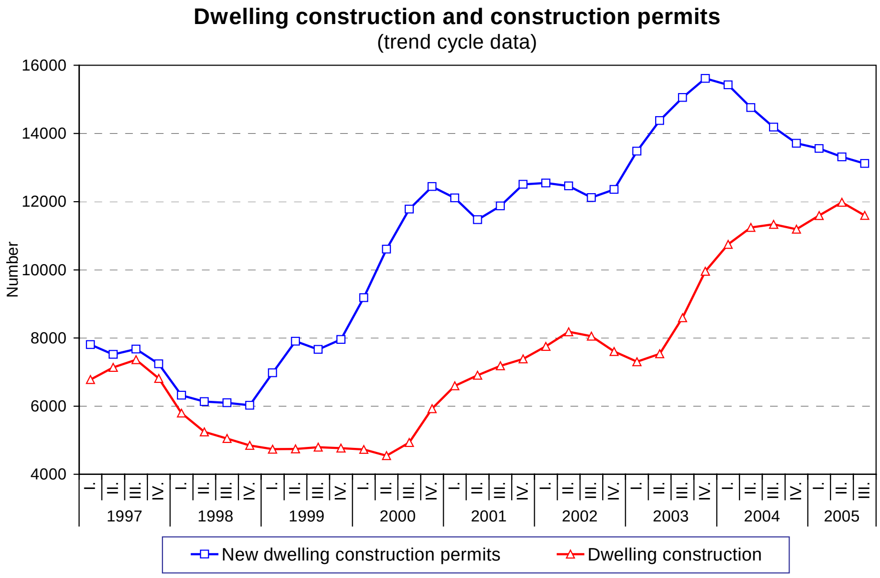
The high investment figures are attributable primarily to the high-volume motorway construction projects. In 2005, 82 km of new motorway was added to the existing road network (Kiskunfélegyháza-Szeged, Balatonszárszó-Ordacsehi, M0); at present, construction is ongoing on 12 sections and preparatory work on additional sections.

Motorway construction is stepping up

For the whole of 2005, 42-44 thousand new dwellings may have been constructed again, i.e., the record of 2004 is expected to have been repeated. According to experts, the rejuvenation of the close to 4.2 million, partly outdated, housing stock would require the construction of at least 42 thousand (1%) new homes a year. Since the time of transition, 2004 was the first year when that many homes were constructed; that achievement is likely to be repeated in 2005.

The number of dwellings put to use continues to be high

In the first nine months, 4.3 % more dwellings were put to use, while the number of construction permits issued was decreased by 9% corresponding the figure one year before. The number of construction permits has been declining continuously in recent quarters, but the decline was moderated by the increased interest in the housing grant available in framework of the Nesting Programme since 1 February 2005. As of 1 November, the age limit for the Nesting Programme was increased by 5 years (to 35), thus some 300 thousand more families may be able to borrow for hosing purposes with a government guarantee.



In the previous flash report an investment growth of 6-8% for the whole of 2005 was forecasted. Based on the positive figures of the first nine months, however, it appears justified to revise the forecast upwards to 7-8%, and actual output is likely to be closer to the high edge of this range. Based on the volume of EU capital transfers, almost twice the previous level figure, and the positive business cycle trends, investment activity of around 8% is probable for 2006.

Around 8 % investment growth in 2005 and 2006

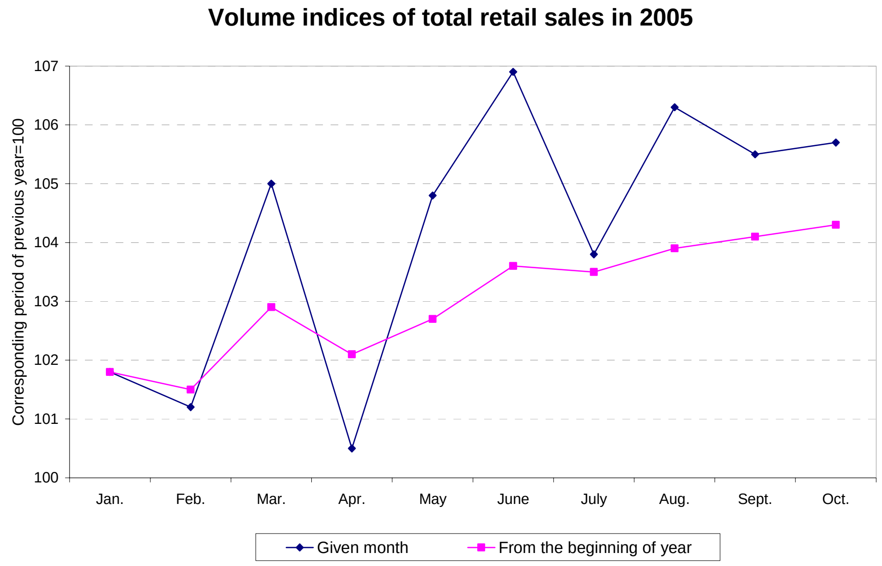
2.3 Retail trade, consumption

In the past three months, the volume growth of **retail trade turnover** accelerated. The sales volume adjusted for calendar effect and without the trade of motor vehicles and automotive fuels was 5.6% higher in January-October than in the corresponding months of the previous year. The turnover of non-food products increased more than that of food, beverages and tobacco retail trade, but the difference in the rates of these two main categories have been narrowing in recent months.

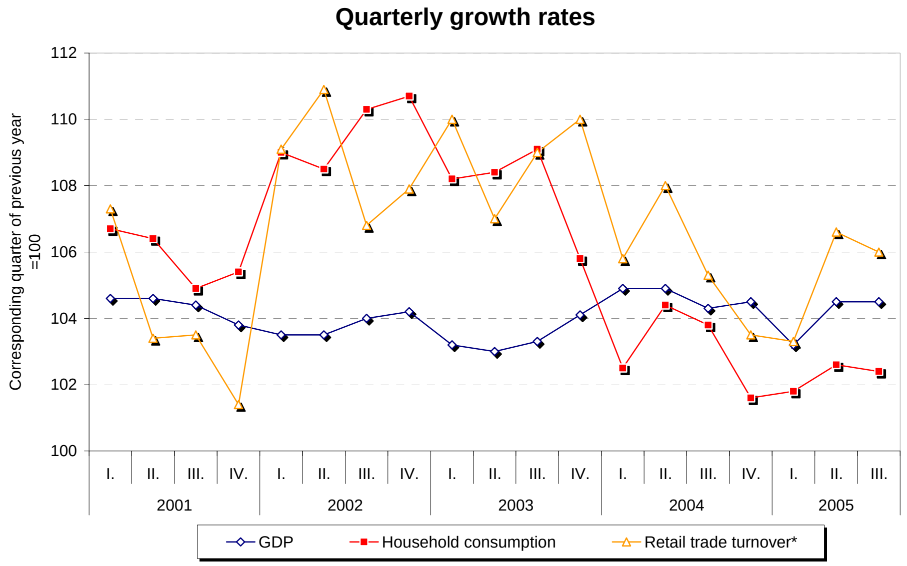
Accelerating turnover growth in the last months

The turnover of motor vehicles and automotive fuels has been increasing since June. The total turnover, without adjustments, increased by 6.1% at current prices, or by 4.3% at constant prices, in ten months. The retail price index (101.7%) was substantially lower than the CPI (103.6%).

The trade of motor vehicles and automotive fuels picking up



Due to the new method of allocating financial intermediation services (FISIM), the CSO retroactively revised downwards the first half-year figures of **household consumption**. As compared to those adjusted figures, Q3 showed only a slight change, thus the volume of consumption increased by 2.3% in the whole of Q1-Q3.



*Without the trade of vehicles and fuels, adjusted for calendar effect

Slightly accelerating consumption growth in 2006

For the whole of 2005, household consumption growth is estimated to be around 3%. This rate is in line with the growth rate projected for 2005 in the Convergence Programme of December 2004.

For 2006, household consumption growth of approx. 3.5% is expected. The rate slightly exceeding last year's level is due to the reduced tax rates and declining inflation, rather than the acceleration of income growth.

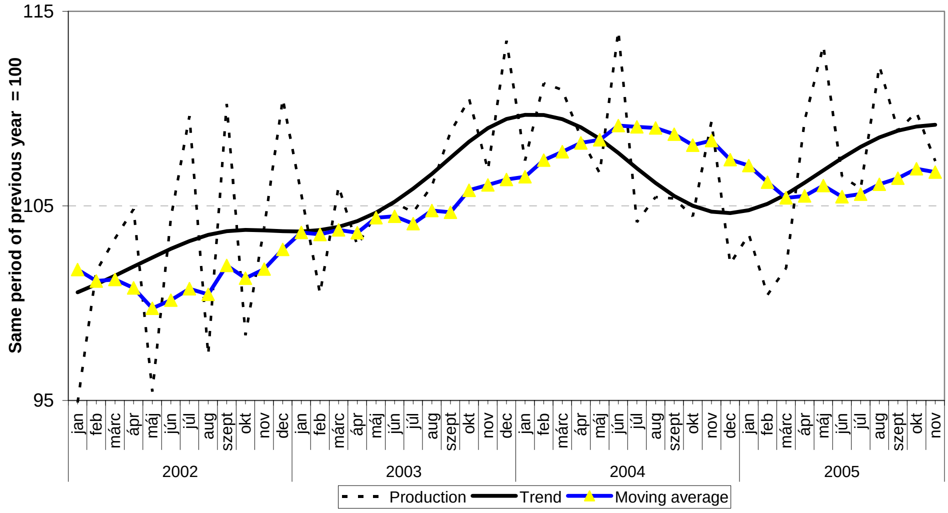
In 2005 the financial savings of households increased substantially as compared to previous years. The savings ratio is expected to stabilise in 2006.

2.4 Output

Industrial output growth continues to grow dynamically

Industrial output was up on the year 2004 figures by 7.3% in the first eleven months, and by 7.7% in November. The trend growth of output was constantly high in the last three months.

Volume indices of industrial production



Along with exports, domestic sales are also increasing

As compared to previous years, last year's industrial output showed a significant change in that domestic sales, which constitute almost half of total sales, produced an increase unseen since 2000, while export sales retained their dynamic growth. According to some analyses, an increasing portion of domestic sales replaces a growing part of importation for production purposes, but the analyses have not provided any conclusive proof for this. This claim can be proved or refuted only with knowledge of the data of the forthcoming months.

Following the slower growth below 2 % in Q1, industrial output rose dynamically, and reached a value close to 10%. Along with dynamically expanding export sales, domestic sales also picked up.

Performance of the industry in 2005

same period of previous year = 100

Period	Output	Sales		
		total	of which:	
			domestic	export
Q1	101.9	102.8	100.4	105.0
Q2	109.6	109.9	105.0	114.4
Q3	108.9	109.9	106.4	113.3
October	109.8	109.5	107.6	111.3
November	107.7	109.7	106.4	112.9
January-November	**107.3**	**108.0**	**104.6**	**111.2**

Nevertheless, output growth is still driven by export sales. Two leading branches of manufacturing continued to generate above-average export rates: the exports of electrical and optical equipment rose by 16% and that of transport equipment manufacturing by 13% between January and November. These two sectors contributed over 64% of manufacturing exports.

Domestic sales of the entire industrial sector rose by 4.6%, and within that, manufacturing increased by 4.3% in eleven months. In the latter area, the domestic sales of the two leading sectors exceeded the average by orders of magnitude during the entire year: the manufacture of transport equipment increased its domestic sales by 25%, the manufacture of electrical and optical equipment by 18%. Even so, despite this major expansion, these two sectors were responsible only for 13.5% of the domestic sales of manufacturing. Due to large government investment projects, the domestic sales volume of the manufacture of other non-metallic mineral products also rose by 18% on a year-on-year basis. The food industry lost out in the import competition resulting from market liberalisation, its output declined by 4% and its domestic sales by 3% between January and November. The domestic sales of the light industry continued to sag.

The volume of new orders increasing

The trend of new orders in November was encouraging, the volume of total new orders being up by 36% and, within that, export orders were 41% higher and domestic orders 13% higher than in November 2004. There was keen interest in the products of the two leading sectors both abroad and domestically.

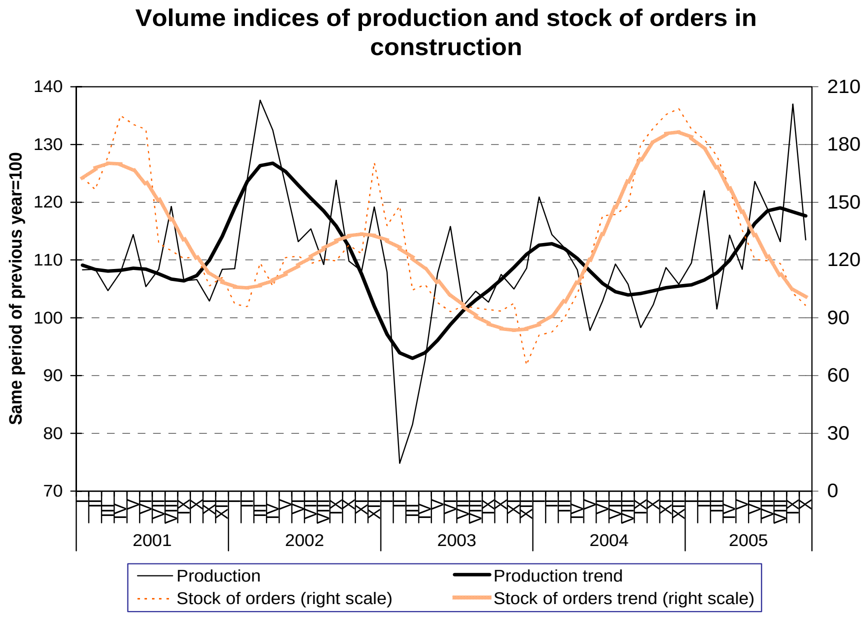
6-8 % growth expected for 2006 as well

The year 2005 growth of industrial output is likely to be around the high edge of the 6-8% forecast. Assuming an unchanged global economic environment, the Hungarian industry will be able to repeat this performance and, if conditions are more favourable, it may even exceed it.

Vigorous growth of construction output

Primarily as a result of road network development projects, the output of construction increased vigorously throughout the year, with the exception of one month, the growth rate being 16.9% in the January-October period. Apart from infrastructure projects, non-recurring factors also contributed to growth, such as the construction of grain storage facilities and the commencement of preparations for several high-value construction projects (university and health care buildings, housing complexes, hotel construction).

The twelve-month ex post index continuously grew throughout the year, reaching 115% in October. The trend values slightly declined after the peak of 119% in August, in October they stood at 118%.



The monthly trend of new contracts concluded in the month was influenced by the major road network development projects launched in 2004, therefore the monthly volume indices produced wide fluctuations in 2005. As a related phenomenon, the order book declined continuously. The 9% drop in the order book for other structures in the first ten months was only partly offset by the 10% growth in the order book for building construction.

The assessment of the order book by producers improved in November, and their willingness to employ increased. The output of construction is likely to have increased by some 15% in the whole of 2005. Construction may come close to its outstanding results of last year in 2006 as well, as a result of the still intensively growing infrastructure projects and other high-volume government (education, health care, etc.) investments.

The second highest cereal crop in the transmission period so far

The harvested volume of cereals exceeded the average for the 2000-2004 period by 29% in 2005. 17% more wheat and 42% more corn was produced than the average of the last 5 years. 9 million tons of corn was harvested as opposed to the expected 7 million tons. According to the survey of 1 August, livestock has continued to decrease, with the exception of sheep.

Agricultural parity improving by 0.4 %

In the first eleven months of the year, the producer price level of agricultural products was 0.4% below the 2004 level, while expenditures of agriculture declined by 0.8%. The producer prices of plant products fell by 2.8%, those of animal products rose by 1.9%.

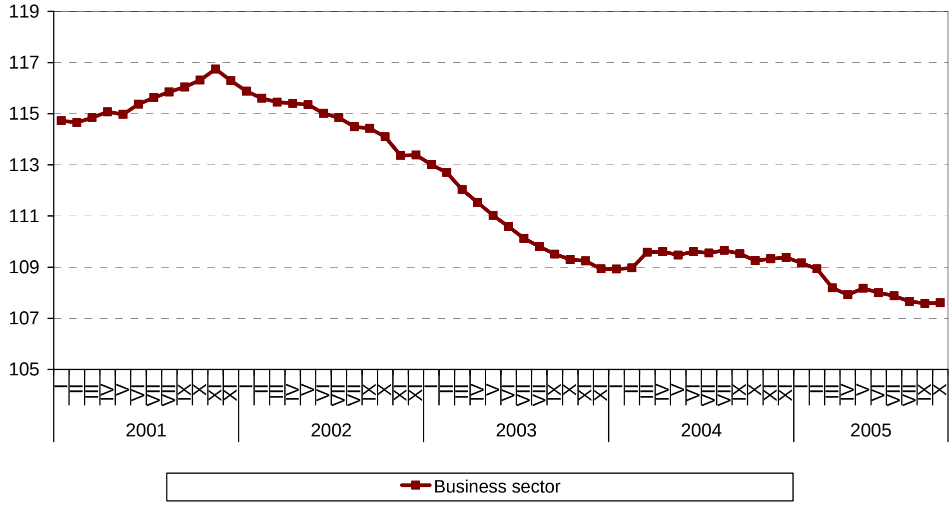
The output of agriculture in 2005 is likely to fall 5-10% short of the previous year figures against the background of improving profitability. For this year we expect last year's results to be repeated, assuming average weather conditions.

2.5 Labour market

According to CSO figures, the monthly average nominal earnings of persons employed full time in the national economy rose by 9.4% in the first ten months of 2005 over the corresponding period of 2004. This is in line with the forecasted annual 8-9% increase of average gross earnings, as the distorting effect of the one-month addition salary in the budgetary sector will be distributed more evenly between months in the remaining two months of the year.

9.4 % gross average earning increase in the national economy,…

Gross average earnings during the last 12 months (previous 12 months = 100)



In the business sector, in line with declining inflation, the rate of wage growth slowed down in 2005. In the first ten months of 2005, gross average earnings increased by 7.1%, at the expected rate, over the corresponding period of 2004. Within the branches of the sector, financial activities (10.3%) and transportation, warehousing, postal services and telecommunication (8.2%) produced an above-average growth.

… and 7.1 % in the business sector

In the budgetary sector, the CSO showed a gross average earnings increase of 14% in the first ten months. The earnings index was substantially higher than the real figure due to the modification of the rule on the payment of the one-month additional salary. After adjustment for that factor, gross average earnings in the sector increased by 7.5% in the first ten months of the year. Within the budgetary sector, every branch produced a gross average earning growth around the average, with the exception of other community, social and personal services (6.4%).

In 2005, net earnings in the national economy increased at a faster rate than gross earnings due to changes in the PIT Act. Because of the abolition of the medium rate of the three-tier tax system effective in 2004, the tax burden was reduced last year, primarily for taxpayers formerly falling in the medium or high brackets. In the first ten months of 2005, net average earnings increased by 8.6% over the corresponding period of 2004 in the business sector, and by

6.6 % real wage increase in the national economy

10.5% in the whole of the national economy. This corresponded to a 6.6% growth of real earnings in the first ten months. Taking into consideration the distribution of the effects of the one-month additional salary, these figures are in line with the 9-10% net average earnings and 5-6% real wage increase forecasted for the whole of 2005.

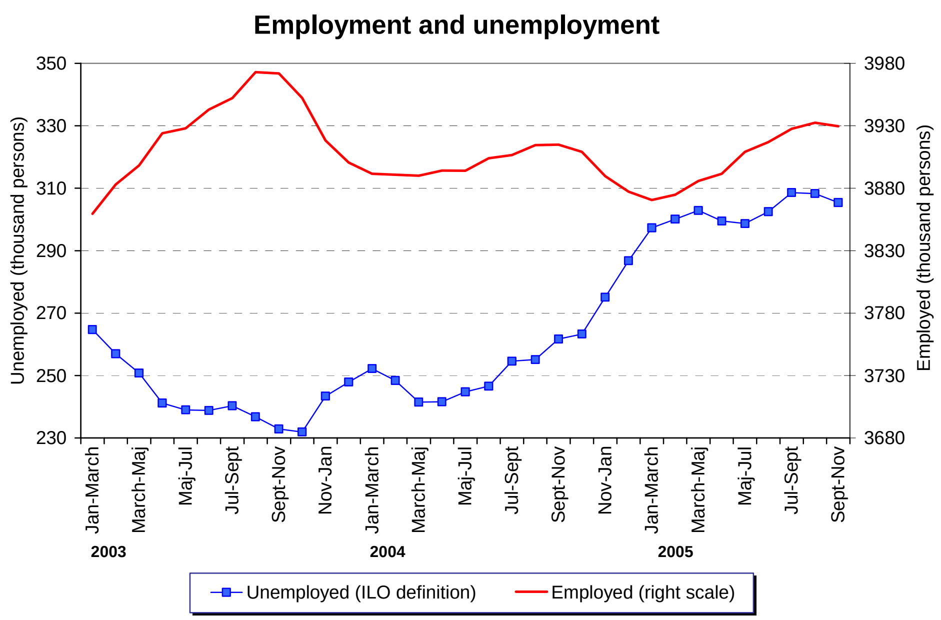
Of the Visegrád countries, only Slovakia produced higher real earnings growth than Hungary (at 6.8%) in the first three quarters of 2005. In the first nine months of the year, real earnings increased by 4% in the Czech Republic and by 1.3% in Poland over the corresponding period of 2004.

Number of employees stagnated, …

According to the institutional statistics of the CSO, the number of persons employed by businesses with at least five employees and by budgetary and social insurance institutions effectively stagnated in the first ten months of 2005; thus 2 million 789 thousand persons were employed on average during this period. Within that, the headcount of the business sector increased by 0.2 %, that of the budgetary sector declined by 1.3 %.

…a slight increase in the number of employed persons

A slightly more favourable situation is revealed by the household labour survey of the CSO; the coverage of this is wider than that of the institutional statistics as it also includes employees of firms with less than five employees and persons working outside employment relationships. Accordingly, in September-November 2005 there were 3 million 930 thousand employed and 305 thousand unemployed persons on the labour market. The number of employees declined by 15 thousand (which is within the error-margin of the sample), while the number of unemployed rose by 44 thousand over the corresponding period of the previous year. The more positive picture results from the trend, which set in in April, after a drop early in the year, and which indicates that the number of employed persons has started a steep rise, while the number of unemployed effectively stagnates, with minor fluctuations. The unemployment rate was 7.2 % on average in the first eleven months of 2005.



As a combined result of the increase of the numbers of employed and unemployed persons alike, the number of economically active persons increased by 59 thousand in the past year, which shows that a significant portion of the inactive have returned to the labour market. The participation rate calculated for the age 15-74 population for the September-November period (54.9%) improved by 0.8 percentage points, the employment rate (50.9%) by 0.2 percentage points over the corresponding period of 2004. The data derived from the household labour survey of the CSO must be treated with some caution, taking into consideration the reliability of sampling.

Increasing activity on the labour market

In the first three quarters of 2005, despite the unemployment rate (7.2%) exceeding the 2004 level, all Visegrád countries had higher unemployment than Hungary (Czech Republic 8%, Slovakia 16.4%, Poland 18.3%). In this period, however, Hungary had the lowest growth rate of the number of employed persons (0.1%) among the Visegrád countries: employment rose by 1.4% in Poland, 1.7% in the Czech Republic and 2% in Slovakia. As a result, in Q3 2005 the employment rate of the 15-64 age group was 57.3% in Hungary, the Czech Republic (65.2%) and Slovakia (58%) reporting higher figures, and Poland (53.8%) boasting lower data.

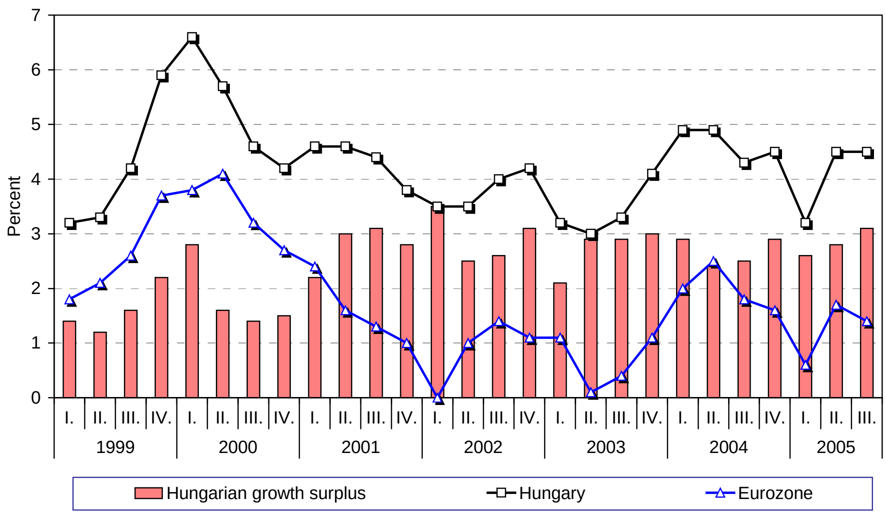
Unemployment rate is rising, but still low by international standards

2.6 Gross domestic product

In Q3, GDP increased by 4.5%, at the same rate as in the previous quarter. In the first three quarters, the growth rate was 4.1%, while the growth rate adjusted for the leap-day effect, which gives a more realistic picture of actual economic trends, is substantially higher (4.4%).

Stable growth…

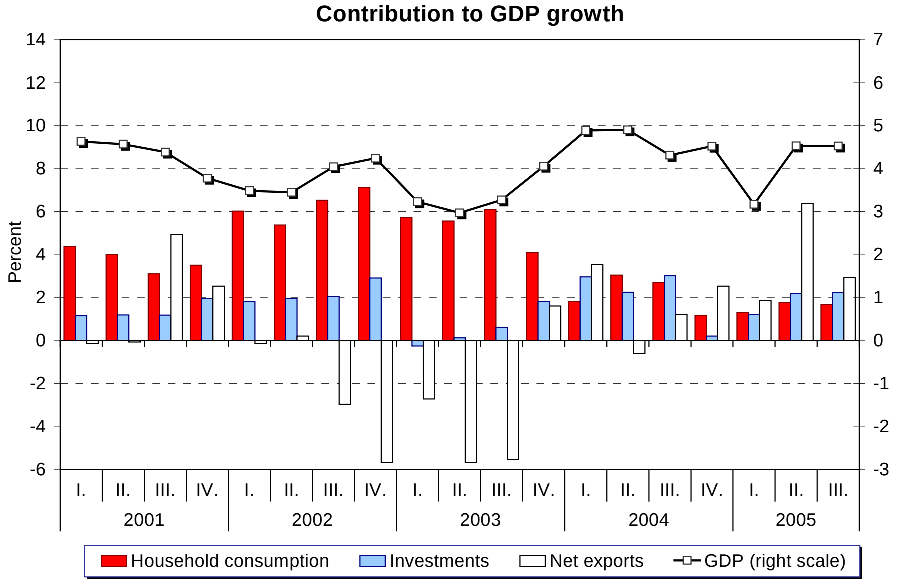
The quarterly GDP growth rate in Euro-zone and Hungary



Growth occurred in a sound structure. It continues to be driven by dynamic investment activity and outstanding export performance, while household consumption has increased at a rate below GDP growth. As a result of the economic policy shift started in 2003, this favourable structure has been continuously perceivable for 8 quarters now, which is key for the long term

…in a sound structure

sustainability of economic growth.



Of the Visegrád countries, the economies of Slovakia and the Czech Republic continued to perform well in the third quarter. Slovakia's growth structure was as favourable as that of Hungary, the driving forces being two-digit exports and investment growth. The dynamic growth of the Czech Republic was primarily due to net exports, while investment growth was rather low (3.2%). Poland continues to be the tailender in the region.

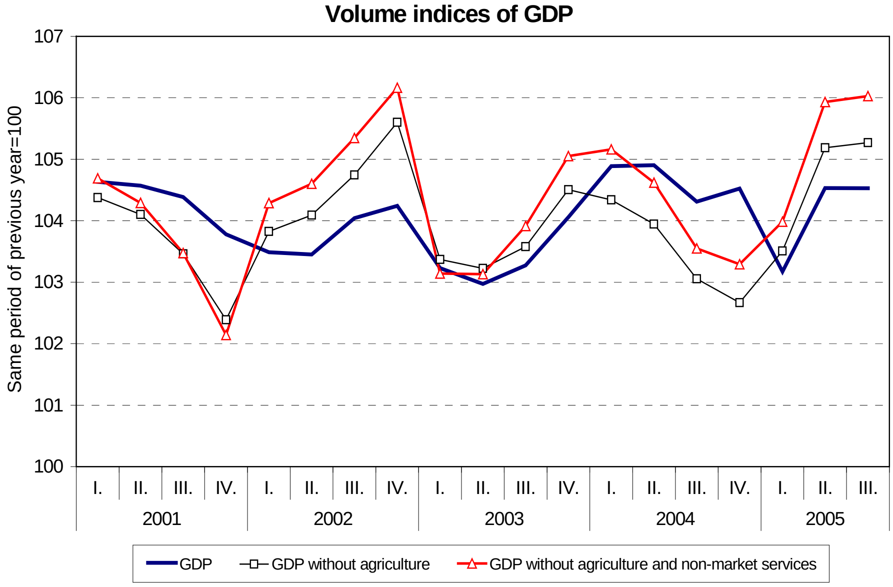
Dynamic investment, sustainable consumption growth and…

In Hungary, household consumption has been expanding continuously, and its growth rate below that of GDP, which is necessary for equilibrium, has stabilised since the beginning of 2004. In Q3, according to the preliminary figures of the CSO, household consumption increased only by 2.4%, even though the continuous expansion of retail trade turnover and the high real wage growth would have suggested greater consumption growth. The growth rate of gross capital formation remained as dynamic as in the previous quarters (9.7%). Both government infrastructure investments and business investments expanded significantly.

…significant net exports are growth drivers

The growth rate of the foreign trade of goods and services continued to be dynamic in Q3. Export growth remained in the two-digit range (11.5%), while import growth, despite the significant acceleration following the modest increase of the first half-year, was a one-digit figure (7.7%). The more modest import performance of the first half-year was attributable to the high basis due to the EU accession of 2004. As in the previous three quarters, net exports contributed mostly to economic growth (+2.9%).

The structure of economic growth is favourable also on the production side. The value added by both the non-service sectors (5.6%) and by market services (4.2%) increased significantly. Agriculture was the only sector to show a decline, mostly due to the high basis of 2005. Despite its 10% decline, agriculture exceeded its year 2000 performance by close to 35%. The value added by non-market services increased at a more modest rate due to the reduction of the expenditures of the budgetary institutions. Without those two branches, GDP growth would reach 6%, which reflects well the sound real economic processes.



Stable growth above 4 % in 2005 and 2006 …

Based on the favourable processes present both on the supply and demand sides, the economic upswing is expected to be stable. The economy is likely to have reached the 4.2% growth projected in the Convergence Programme for 2005, which is slightly higher than the 4% forecasted for the budget of 2005. Taking into consideration the leap-day effect, growth is even more robust (4.4%).

There are no signs warning of any downturn or even any major slow-down in 2006; both the Hungarian and the global economies are likely to be in the ascending stage of the business cycle. The significant improvement of the business confidence indices (GKI, Purchasing Manager Index) in the second half-year also indicates stable economic growth. The 58 point value of the Procurement Manager Index published by the Hungarian Association of Logistics, Purchasing and Inventory Management is the highest during the 10-year history of the survey. Based on the stock of orders, the scarcity of capacities and the significant direct investment inflow, the momentum of the industry may continue this year. The economy may proceed along the sound, sustainable growth path in 2006 as well, with a GDP growth of around 4.3%. Investments and exports may continue to be the driving forces, and real earnings growth will stay in line with productivity growth.

…according to domestic and international forecasts

For 2006, international organisations (EU, OECD), the NBH and domestic economic research institutes (GKI, Ecostat, Kopint-Datorg, Pénzügykutató) alike forecast GDP growth between 4-4.5%. Within that, the projections of the NBH and the OECD appear to be the most optimistic, with growth rates of 4.5%.

3. Inflation

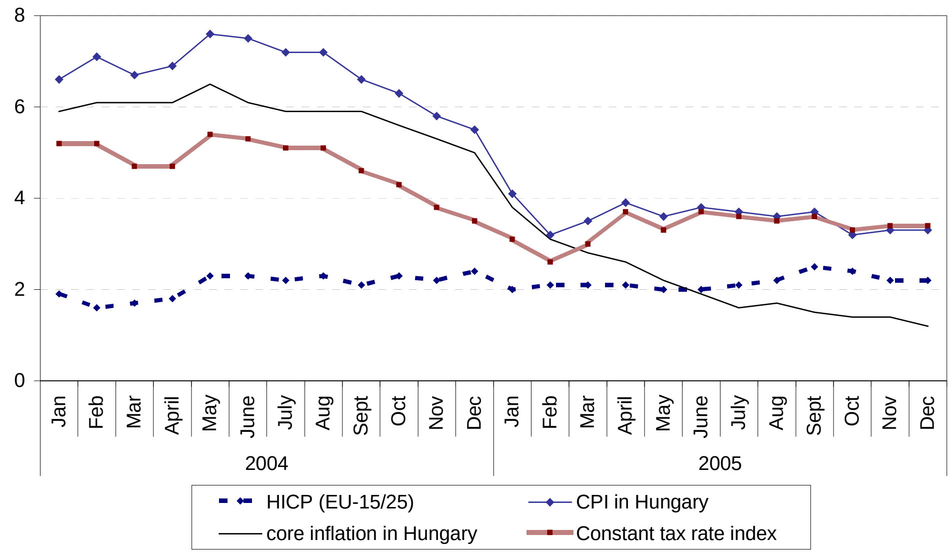
Annual inflation at a historic low

In the past year, the Hungarian economy adopted a more favourable inflation course; consumer price inflation was 3.6% on average for the year 2005 and 3.3% in December. That annual inflation rate is the lowest in thirty-one years.

Decelerating inflation is attributable primarily to the slowdown of wage increases, the continuously strong exchange rate and the effects of EU accession on intensifying competition both on the supply side and in the commercial sector, which is difficult to quantify but is still perceivable. The temporarily rising rate of price increases in the previous year were not incorporated in expectations either. On the other hand, the price increase of fuels and energy in international markets created inflationary pressures. The effects of the latter are only partially reflected in the Hungarian consumer price index because of compensation mechanisms applied to regulated household energy prices.

Inflation trends in Hungary and in the European Union

change in comparison to the corresponding month of the preceding year, per cent



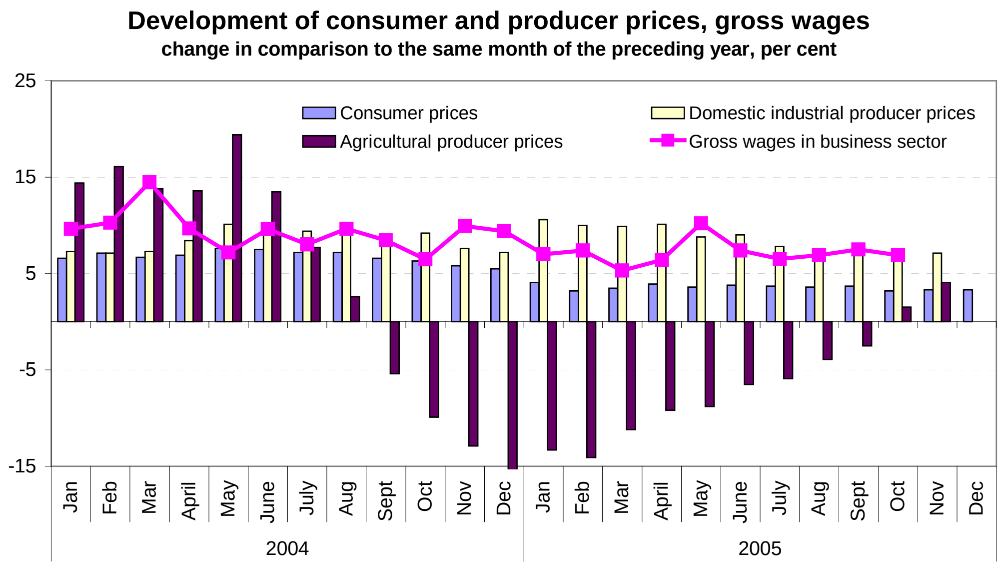
The decline of the core inflation rate continued in 2005

The strong internal factors of Hungarian disinflation are highlighted by the fact that in a stagnating or slightly rising European inflationary environment, the Hungarian price index, calculated net of tax changes, produced a steady decline after mid-2004 and stabilised in the second half of 2005. In the second half of the year, price levels remained unchanged with minor fluctuations. The sustainability of the low Hungarian inflation is supported by the core inflation indicator (which is adjusted, inter alia, for the direct effects of energy price increases) sinking from the previous higher levels to below 2% in mid-2005.

On the supply and costs sides the slowdown of wage increases, being increasingly aligned to the altered inflationary environment, reinforces steady disinflation. As another argument for long-term disinflation, the decelerating expansion of household consumption and the slowdown of wage increases on the supply and cost sides have brought about the deceleration of the price increases of market services.

On the demand side, it is important for inflation trends that despite real wage growth being faster than in 2004, household consumption expanded at a moderate rate while public consumption showed a slight decline.

International and domestic producer and commercial competition continues to be keen, which creates a favourable inflation environment by checking producer prices. The moderating effect on prices of intensifying competition has further reduced the domestic inflation of consumer goods and clothing articles, and kept it below 2%, effectively meaning price stability. This is also true for an increasingly wide range of processed food products. The low price level of agricultural products that emerged in the past period moderates the prices of unprocessed food products.



High oil prices have direct inflationary effects on energy producing sectors and fuels. Furthermore, they exert continuous inflationary pressure on other sectors of the economy, but as a result of strong competition there is limited inflationary ripple effect. This is further enhanced by the continuously improving energy efficiency of the Hungarian economy.

Inflation in 2005 was more favourable than expected

As the combined result of factors conducive to strong disinflation, the 3.6% average annual price increase of 2005 was lower than the 4.5% expectation set forth in the year 2005 budget and in the Convergence Programme of 2004. The twelve-month December inflation of 3.3% was also lower than the 4% envisaged in the 2004 Convergence Programme; it was below the 4% target set by the NBH (though remained within the tolerance range) and it was also below the NBH forecasts, which ranged between 4-4.3% during 2004.

Inflation in 2006 may fall below 2% mainly due to the VAT rate cut

In 2006, in addition to general economic processes, the lowering of the standard VAT rate from 25 to 20% will have the greatest effect on consumer prices. During the year, the rate of inflation may temporary fall to around 1%, while the average rate is likely to be below 2% for the year on average. Significant nominal price cuts are expected across a wide range of manufactured goods. As a result of earlier processes, a modest (but higher-than-average) price increase is expected among market services. Food prices are likely to show an increase around the average rate. There are price pressures on certain services subject to regulated price regimes; these are offset by budgetary or other compensation techniques (household gas, electricity, long-distance transportation). The international environment is effectively non-inflatory, fierce competition curbs the ripple effects of energy prices on consumer prices.

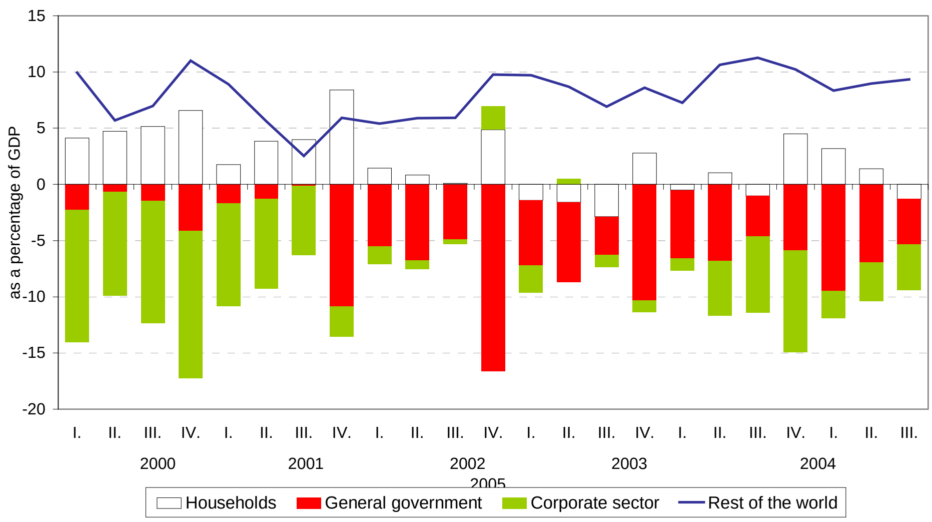
4. Income and financial developments

4.1 Equilibrium

The external financing requirement of the economy as a percentage of GDP declining in 2005

Even though the difference in the level of data, which has been observed since 2004, is still present, both the BOP data and the financial accounts indicate that the external financing requirement of the Hungarian economy declined in the first three quarters of 2005. The external equilibrium indicator, from the financial account angle, corresponded to -8.9% of GDP, reflecting an almost 1 percentage-point improvement over the January-September period of 2004. The improvement was facilitated by household savings more than doubling, despite the very low figure in the third quarter in line with usual seasonal trends. In addition, the financing need of the corporate sector was also lower than one year before (financial and non-financial corporations together: 3.3% of GDP). Within the corporate sector, the financing requirement of non-financial enterprises was similar to the previous year level, slightly declining as a percentage of GDP (4.1% as opposed to the 4.6% in Q1-Q3 2004). As a result of government measures, the growth of the general government deficit significantly slowed down in Q3.

Financing requirement / capacity of sectors*



/*: According to the financial accounts, private pension funds in general government sector

For the entire year, the external financing requirement is expected to have fallen by more than one percentage point, amounting to some 7-7.4 % of GDP from the angle of non-financial accounts. Even though the financing requirement of the general government increased by over half a percentage point as compared to 2004, the savings of households rose by cca. fifty percent. Without private pension fund savings, households contributed some 2% of GDP to the financing of the economy. The financing requirement of the corporate sector, as a percent of GDP, is likely to have fallen in the whole of 2005, similarly as in the first three quarters.

In 2006, taking into consideration the stabilised savings ratio of households, the further improvement of the external equilibrium may be promoted mainly by the envisaged reduction of the general government deficit.

4.2 General government

The 2005 cash deficit is almost HUF 40 billion lower than budgeted

Based on the cash data, in 2005 the deficit of the central government was HUF 984 billion, close to HUF 40 billion less than the original HUF 1023 billion appropriation or the almost identical HUF 1021 billion forecast. The central budget showed a deficit of HUF 545 billion (77.9% of the original appropriation), the social security funds generated a deficit of HUF 470 billion (127.7% of the appropriation) and the extra-budgetary funds produced a surplus of HUF 30 billion (165.2% of the appropriation). The better-than-expected balance was attributable to the December surplus of HUF 213 billion, more than 40 billion HUF higher than the preliminary forecast.

Non-recurring revenue overruns and ...

The sale of Budapest Airport Rt. in December was conducive to the favourable cash balances. The amount out of the HUF 465 billion sales price paid for the asset management rights and the movable property increased the budget revenues, while HUF 60 billion privatisation proceeds was paid to ÁPV Rt. for the sale of the shares. Furthermore, the forecast did not reckon with the approx. HUF 80 billion proceeds from MOL Rt, paid partly for the ownership title of the cushion gas, partly under other titles as mining rent.

...tax revenue shortfalls...

On the other hand, the tax and tax-type revenues of the budget fell some HUF 300 billion short of the appropriations. The contribution revenues of the social security system were also HUF 35 billion less than originally budgeted. The revenue shortfalls were caused partly by the base effect (the actual year 2004 revenues turned out to be lower than projected during the drafting of the 2005 budget), partly by the lower-than-expected inflation and slower expansion of employment, and partly by the approx. HUF 127 billion VAT reimbursement carried over from 2004 to the first half of 2005.

Based on the first half-year trends, the Ministry of Finance adjusted the revenue forecasts downwards. In order to stay within the budgeted deficit, the Government decided upon additional measures in the middle of the year to increase revenues and curb expenditures. The favourable deficit figure reflects the effects of those measures as well. On the whole, the tax and contribution revenues, with the exception of one special item, did not fall short of the July forecasts. More personal income tax and excise tax revenues and less corporate income tax and contribution revenues were realised than foreseen at mid-year. The HUF 110 billion difference in VAT revenues is almost entirely explained by the fact that, the amount expected from ÁAK Rt, related to the change of the financing arrangement of motorways,. was not remitted eventually.

Partly as a result of the measures implemented during the year (restoring of the previous VAT imposition system in case of importation from non-EU countries, broadening of the social security contribution base, tax raise on slot machines, stricter controls at the borders to combat the smuggling of fuel and tobacco products), eventually excise tax receipts were only marginally below the appropriation. The VAT revenues were smaller in December than in the previous months due to large reimbursements.

...accompanied by expenditure overruns, but...

On the expenditure side, pension expenditures and pharmaceutical subsidies were higher than budgeted, and housing subsidy expenditures also exceeded the appropriation because of the outstandingly high payments disbursed in December. In line with the amendment of the Budget Act, the budget assumed the HUF 178 billion debt of the NA Zrt in December. Thus the former equilibrium-improving effect of motorway-related revenues was neutralised. The surplus of debt service expenditures is explained mostly by the debt repayment from part of the proceeds from the sale of the Budapest Airport: the difference between the market value paid and the book value was disclosed on the interest expenditure line among current expenditures.

...savings at budgetary institutions

In 2005, the balance of the expenditures and revenues of budgetary institutions and chapter-managed appropriations improved the budget position. The increase of the net expenditures (without expenditures covered by own revenues or EU transfers) of institutions slowed down perceivably in the second half-year as a result of government measures requiring tighter financial management (extraordinary general government reserves, retention of carried-over unspent appropriations). In line with the usual seasonality (at year-end, larger amounts were paid out in previous years as well), the net expenditure in excess of HUF 240 billion in December is over one and a half times the average monthly sum since July, but for the entire year the net expenditures of budgetary institutions and chapter-managed appropriations were over 20 billion HUF less than the appropriations plus reserves (the reserves are typically used by the budgetary institutions). Taking into consideration that the payments made by the central budgetary institutions were HUF 44 billion higher than originally envisaged, the system of institutions on the whole improved the balance of the budget by HUF 66 billion as compared to the original appropriation.

The ESA deficit projection was also achieved

The accrual-based balance accompanying the cash data will be published following the data disclosure to Eurostat in March. According to preliminary estimates, the deficit forecast of 6.1% of GDP (together with private pension funds), as included in the Convergence Programme of December was achieved in 2005.

1.4 percentage-point ESA deficit reduction in 2006

In the Convergence Programme, the Government set the objective of implementing a 1.4-percentage-point adjustment by reducing the ESA95 deficit (together with private pension funds) to 4.7% of GDP in 2006.

The Budget Act approved by Parliament in December, essentially in accordance with the submitted Budget Bill, set the cash deficit of the central government at HUF 1546 billion (6.6% of GDP). The structure of the approved balance sheet was slightly modified: more transfers given to local governments, housing construction and families through re-allocations from the appropriations of budgetary institutions and from the general reserve. The approved year 2006 budget contains the assumption of HUF 178 billion of the debt of NA Zrt. However, as this occurred already in 2005, the balance remains unchanged, and both the revenue and expenditure totals of the budget are reduced by that sum.

During 2005, the gross debt of the central government is expected to have risen from 56.8% to 58.4% on cash basis, and ESA95 public debt adjusted for private pension funds from 57.2% to 57.7% of the GDP.

Lower-than-expected public debt stock as a result of the Budapest Airport privatisation

In 2005 the cash based gross debt of the central budget turned out to be lower than originally envisaged due to the lower financing requirement and the pre-payment from the receipts for Budapest Airport, increasing during the year by a total of HUF 1152 billion, or 10%. The Government spent the majority of the privatisation receipts towards debt repayment. Approximately half of that sum resulted in the pre-payment of public debt towards the NBH, which was implemented following consultation with the central bank and in a fully market compatible manner.

Composition of the central government gross debt

	2004		2005		Change	
(HUF billion)	close	%	december	%	HUF bn	%
FX	***2 983,5***	***25,7%***	***3 590,7***	***28,2%***	***607,2***	***20,4%***
Government securities	2 066,8	17,8%	2 870,0	22,5%	803,3	38,9%
Loan (marketable)	561,1	4,8%	624,6	4,9%	63,4	11,3%
NBH loan	355,7	3,1%	96,1	0,8%	-259,6	-73,0%
HUF	***8 608,8***	***74,3%***	***9 153,5***	***71,8%***	***544,7***	***6,3%***
Government securities	8 604,2	74,2%	9 152,6	71,8%	548,5	6,4%
Loan (marketable)	4,7	0,0%	0,8	0,0%	-3,8	-80,9%
Total	***11 592,4***	***100,0%***	***12 744,2***	***100,0%***	***1 151,8***	***9,9%***

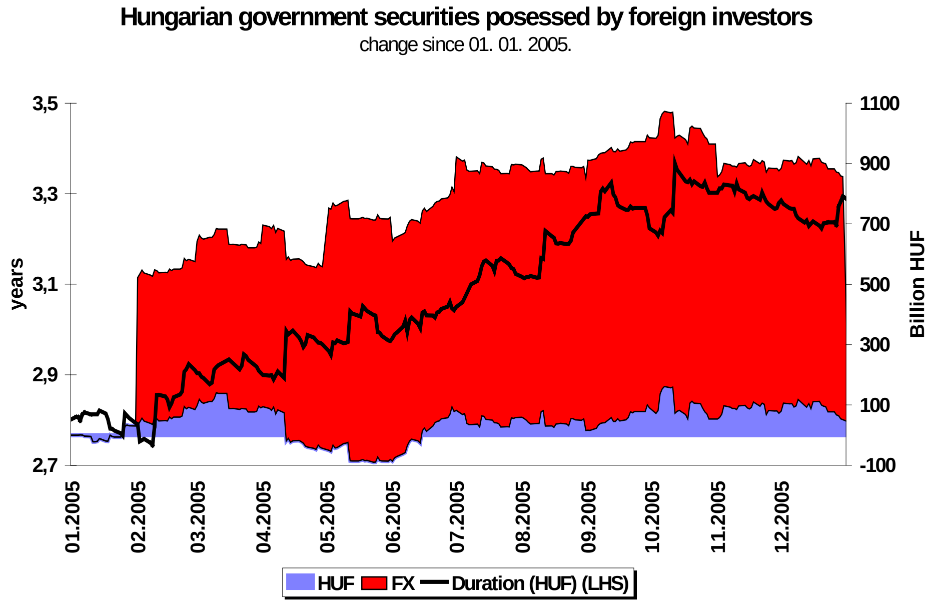
Note: Data are cash based and not consolidated by private pension funds' stock of government securities.

The published ESA 95 public debt figures contain the central budget debt as well as the debt of government agencies classified in the government sector by ESA95 (e.g. local governments, ÁPV Rt., NA Rt., media companies, non-profit organisations, etc.). However, because of the adjustment for private pension funds, the ESA95 debt ratio adjusted for private pension funds is expected to be 0.7 percentage points lower than the debt ratio of the central budget, i.e., 57.7%. Private pension funds hold in their portfolio government securities corresponding to 3.8% of GDP.

Consequently, the accrual-based debt ratio practically remained unchanged in 2005. In all other respects the development of public debt was in line with the debt management strategy also outlined in the Convergence Programme. The ratio of foreign currency debt, the fixed-variable composition and the maturity structure all remained within the set band. (The development of public debt in the past 10 years is reviewed in Annex 2.)

On the whole, the conditions of financing were favourable in 2005: during the year yields declined significantly, though they started climbing in the fourth quarter, and the financing of the budget was in line with the debt management strategy objectives. The foreign currency and Forint-denominated government security portfolio held by non-residents rose slightly, accompanied by higher duration.

Stable financing, improving conditions



The basis for financing in 2006 is the financing plan disclosed by the ÁKK in December at a press conference. Accordingly, in 2006 the total net financing requirement of the central government, the social security fund and the extra budgetary funds will be HUF 1583 billion. The gross debt repayments are expected to be HUF 6 011 billion in 2006, which is 2% less than the repayments made in 2005. The gross new government securities issuances will be 3% higher in 2006 than in 2005 and, within that, Forint denominated government securities issuances will be 12% higher. That is because in 2006 the government intends to maintain the Forint-foreign currency ratio at an unchanged level, therefore the role of Forint financing will be significantly greater than in 2005. The Government Debt Management Agency will continue to raise the majority of the net Forint issues through government bonds. 35% (HUF 2529 billion) of the gross issuances will be in the form of government bonds, of which HUF 2024 will be Forint, HUF 505 billion foreign currency denominated. The envisaged EUR 2 billion government foreign currency borrowing is 50% of the 2005 level.

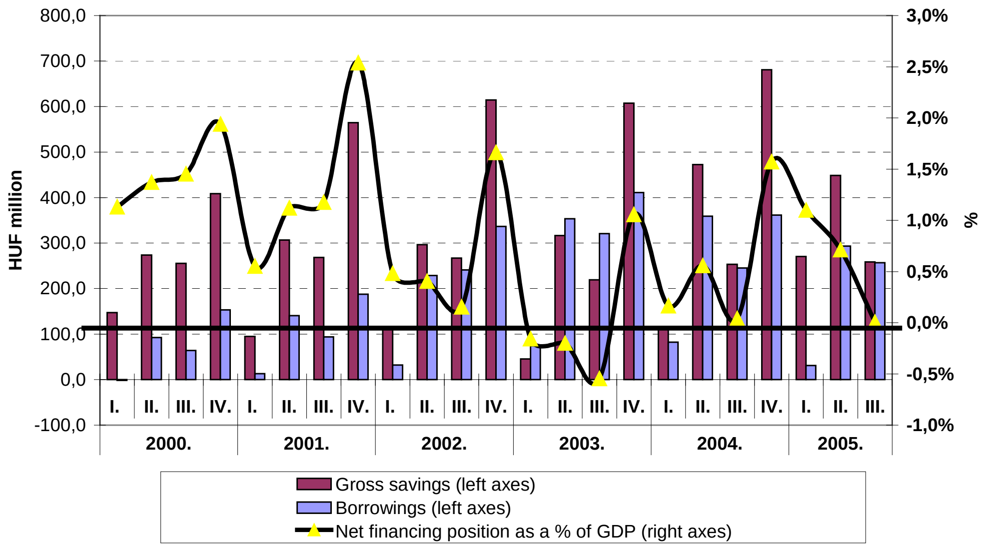
The share of Forint financing will increase in 2006

4.3 Financial savings of households

In the first three quarters of the year, the net saving position of households amounted to almost HUF 400 billion. The increase arose in the first half-year. In Q3, the net financial assets of households did not continue increasing.

The financing capacity of households improved in the

Development of gross savings and borrowings of households and their net financing position as a % of GDP



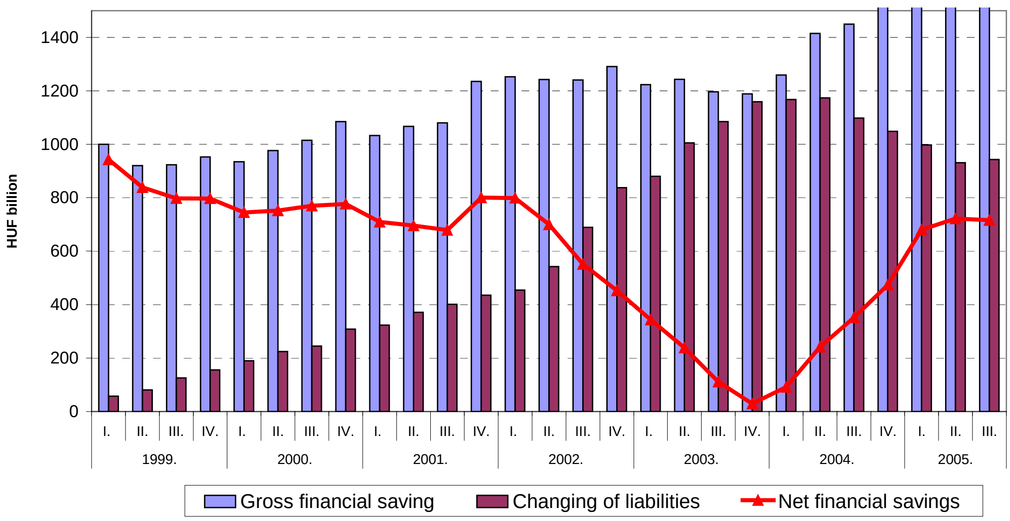
The rising trend of the 12-month cumulative gross savings, which had started at end-2003, came to a halt in Q2. This was partly attributable to the effects of declining nominal interest rates. In the first three quarters of 2005, the expansion of investment units and pension and life insurance savings arrangements dominated. The dynamic growth of investment units is related to declining yields, while pension and life insurance savings have been steadily growing elements of household savings because of the characteristics of the pension system. Among household savings, listed stocks continue to represent an extremely low proportion, amounting to 1% of savings.

Foreign currency loans continue to dominate

Following the low values in Q1, in Q2 and Q3 the expansion of the credit stock of households resumed the approx. HUF 200-300 billion level seen in previous quarters. In their borrowing decisions households continue to prefer foreign currency loans to Forint loans. In the first three quarters, households borrowed 88% of their new loans in foreign currencies. The foreign currency loans represented some 39% of the total loan stock after the end of the first 9 months of the year.

In effect, households have a requirement for financing in Forints, foreign currency arrangements are used only because of the lower interest rates. The propensity of households to borrow in foreign currencies was also increased by the low fluctuation of the Forint exchange rate, therefore they did not perceive the risks entailed in foreign currency borrowing. During the first three quarters, the foreign currency borrowing of households generated Forint demand of approx. EUR 2.4 billion, which contributed to the financing of the current account deficit and to maintaining the strong and stable exchange rate. With the foreign currency loans, households purchase consumer goods or real estate for Forints, therefore the currency loan is converted to Forints at the moment of borrowing. This creates a demand for Forints as banks, in order to minimise risks relating to loans raised and extended, offer on the currency market foreign currencies corresponding to the sum of the foreign currency loans extended. At the time of repayment, the process works in the opposite direction. Households repay the loans in Forints, but the lender converts the amount back into foreign currency. This process increases the Forint supply. When the propensity of households to borrow in currency declines and the repayments exceed the demand for new foreign currency borrowing, excess Forint supply will emerge, which will work towards weakening the Forint.

Development of net financing position of households
(12 month accumulated values of transactions)



Growing savings reduce the external financing requirement

For the whole of 2005, the financing capacity of households may be around 3% of GDP (approx. 2% after adjustment for pensions), which is almost one and a half times the year 2004 figure. Because of the VAT rate cut of 2006, declining credit demand below the usual levels is expected in the remaining part of the year 2005. We reckon with growing gross and net saving stocks and financing capacity as a result of the seasonal rise in the Q4 incomes. We expect no change in the structure of savings in Q4 2005.

As a typical development in 2005, the Forint demand arising from the currency borrowing of households became a determining factor in the Forint market. The monthly growth rate of foreign currency borrowing is expected to be around EUR 300 million during the last months of the year as well, therefore the Forint demand of households is expected to be above EUR 3 billion on the whole in 2005. Because of the different denomination of household savings and borrowing, the investment demand of households in Forint is approximately twice (6% of GDP) of their net saving position. This factor contributed to the favourable trends on the Forint securities market last year, and may assist in the increasing financing of the general government from the Forint market this year.

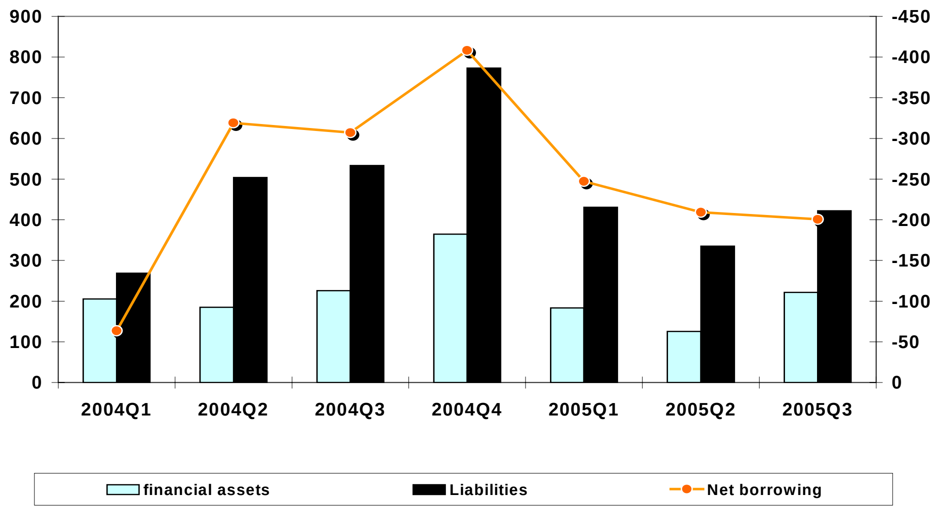
4.4 Corporate sector

Foreign funds dominate in financing

In the first three quarters of 2005, the financing requirement of the corporate sector (without credit institutions) was similar to the level seen one year earlier, but its distribution between quarters was much more even. The financing requirement in the first nine months amounted to almost HUF 650 billion, satisfied mostly from foreign sources. The financing requirement of non-financial enterprises as a percentage of GDP showed a declining trend in the first three quarters of last year, amounting to some 4% in aggregate. Domestic funding represented 30%, and the ratio of foreign funding increased both as a whole and within the year.

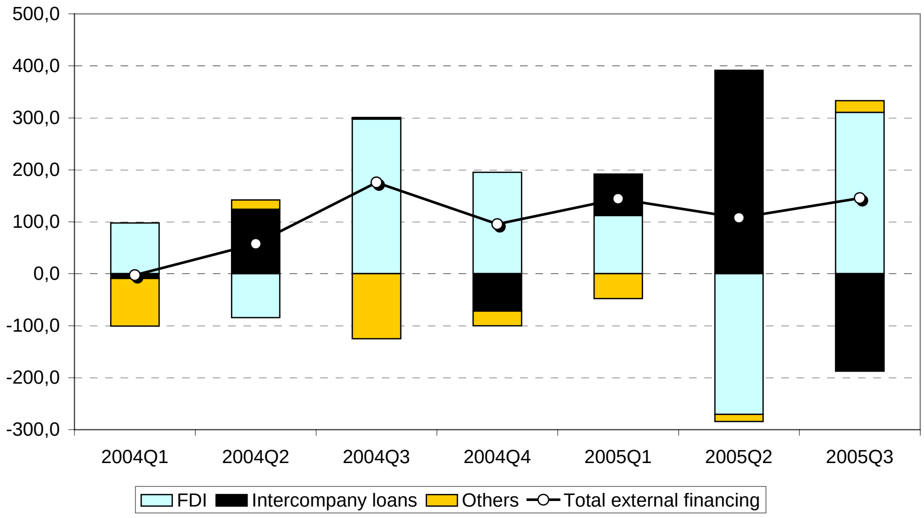
The net financial worth of non-financial enterprises continued declining in the first three quarters of 2005, by almost HUF 3000 billion, which was explained mainly by revaluation rather than transactions. The assets of enterprises also increased, but the rise of liabilities is especially noteworthy: this change is explained by the soaring stock exchange. In addition, the open foreign exchange positions of companies also increased: their liabilities grew at twice the rate of their assets, which is attributable primarily to transactions.

Non-financial corporations' net borrowing



The balance of payments data reveal a significant change in the structure of foreign financing in Q3: within direct investments, acquisitions regained priority over inter-company loans. At the same time, this reinforces the assumption that these two categories are substitutes and companies classify their funds into one or the other category depending on the prevailing situation. On the whole, foreign fund raising increased in Q3. The activities of Hungarian activities abroad developed similarly in the first three quarters as in the corresponding period of 2004, i.e., a significant outflow of capital occurred. On the other hand, this activity significantly declined in Q3, capital was even withdrawn from abroad, which is unlikely to be a lasting tendency in light of the regional expansion strategies of major Hungarian companies.

External financing of the corporate sector



For 2006, an economic upswing is expected on the major export markets, therefore the Hungarian economic activity may continue to expand. Consequently, enterprises are likely to need funding at least at last year's levels in 2006 as well.

4.5 External equilibrium[3]

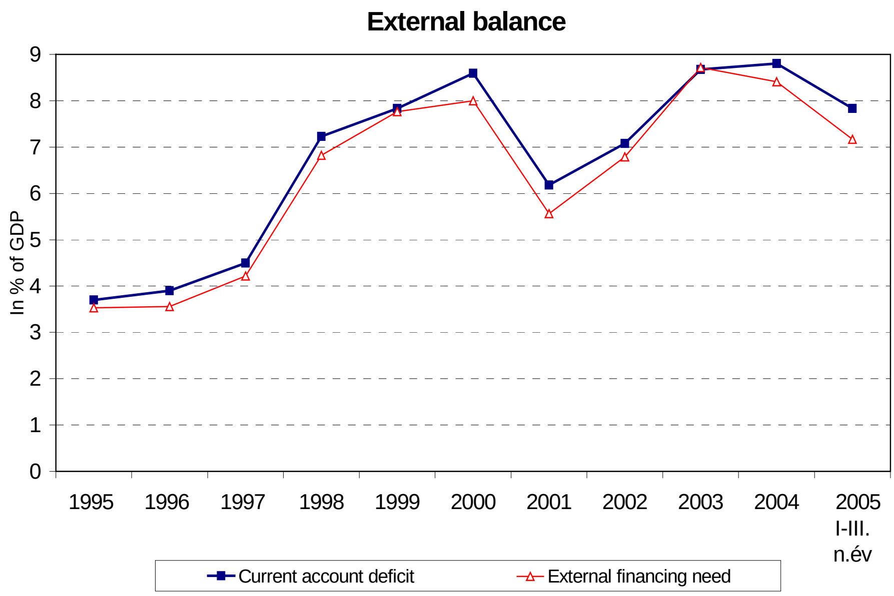
The current account deficit and…

The external equilibrium improved significantly from Q2 2005 onwards. At the end of September 2005, the current account deficit was EUR 5,053 million, or 7.8 % of GDP. This represents an improvement of EUR 285 million, or 1.3 percentage points of GDP, over the EUR 5339 million deficit at the end of the first nine months of the previous year. The improvement was the result of the decrease of the trade deficit in the first half-year significantly over-compensating the deterioration of the income balance.

…the external financing need going down…

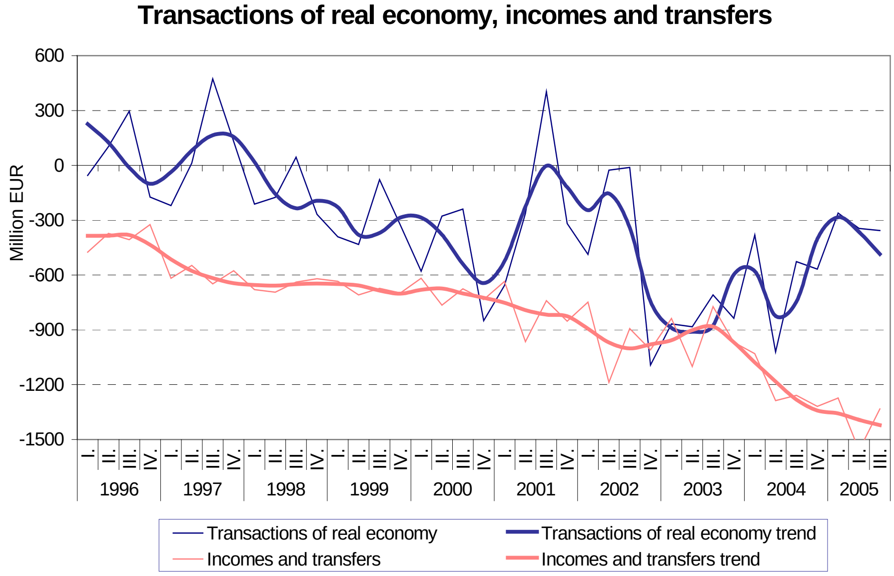
Alongside the decreasing current account deficit, the capital account balance improved significantly: Hungary received additional funds of EUR 429 million through EU capital transfers. This further reduced the external financing need, bringing it down to 7.2% of GDP from last year's level of 8.9%.

[3] Based on the NBH data published on 30 December 2005.



The deficit of the foreign trade balance was almost EUR 1 billion lower than in the base period. Services performed similarly to last year, reducing the current account deficit by EUR 158 million. The deficit of the trade of goods and services fell from 3.3% of GDP to 1.5%.

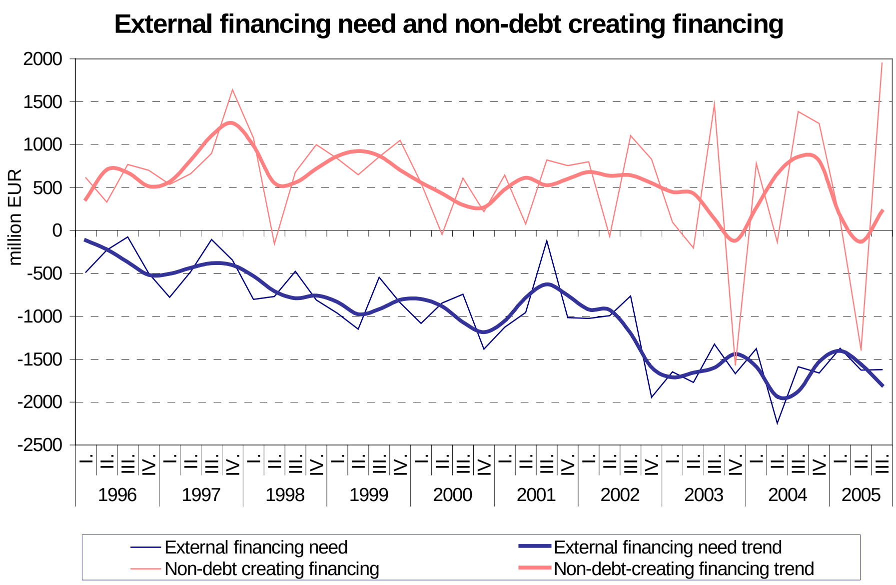
…mainly due to the lower trade deficit



The deficit of the balance of incomes became the major item within the current account deficit, reaching 6.5% of GDP in the first thee quarters as opposed to 6.1% last year. The value of interest and dividend type of income at EUR 4.2 billion was EUR 0.6 billion up on the figure registered in the third quarter of 2004. Three quarters of the increment resulted from the increase of incomes realised on the expanding foreign investments. The continuous expansion of the stock of foreign direct investments and the profitable operation of the capacities thus created is a positive development, and it necessarily goes hand in hand with the increase of dividend income in the balance of payments. Owners are expected to re-invest a substantial part of the profit in Hungary; in Q3, the reinvested income amounted to over half of total profits. The remaining part of the increment arose as a result of the greater debt stock and the high interest rates in the first half of the year.

Non-debt-creating financing increased substantially in Q3

By end-September 2005, the value of foreign direct investments in Hungary amounted to EUR 2.8 billion, a level similar to the base period. The direct investments of non-residents were made primarily in the form of inter-company loans. In line with regional expansion, in the first half-year the investments of Hungarian residents abroad expanded significantly. As a combined result, the net FDI inflow declined by some EUR 0.4 billion. At the same time, in line with international trends, almost EUR 500 million outflow occurred through the portfolio channel in the first half-year. Q3 brought about a turnaround, the FDI by non-residents increased significantly, while the outward investments of Hungarian companies fell to the minimum, and a net inflow of EUR 0.6 billion was realised through the portfolio line. As a combined result, in Q3 120% of the current account deficit was funded by non-debt-creating financing. However, in the first three quarters non-debt-creating funding financed 15% of the current account deficit due to the negative figures of the first half-year. For the whole of 2005, however, together with the approx. EUR 2 billion privatisation proceeds (Antenna Hungária and Budapest Airport) in Q4, non-debt-creating funding financed over 60% of the current account deficit.



The gross debt (without other capital, i.e., inter-company loans) increased by EUR 8.5 billion to EUR 55.8 billion as compared to December 2004. Within that, the debt of the general government and the NBH increased by EUR 4.9 billion to EUR 28.2 billion, that of the private sector by EUR 4.9 billion to EUR 28.2 billion. The EUR 14.6 billion of international reserves exceeded the December 2004 level by 2.9 billion; together with privatisation proceeds, the reserves at year-end rose to EUR 15.7 billion. During the three quarters, the net debt (without other capital) increased from EUR 21.5 billion to EUR 24.8 billion, the debt of the general government and the NBH increased by EUR 0.6 billion to EUR 12.3 billion, that of the private sector by EUR 2.7 billion to EUR 12.5 billion. The share of the private sector within net debt rose by 5%. In Q3 the indebtedness of the private sector dominated both within gross and net debt growth. At the end of 2005, privatisation proceeds reduced the general government debt by more than EUR 1.5 billion, and, depending on the debt growth of the private sector, the gross debt may be close to the level seen at end-September or stay below it by EUR 0.5-1.0 billion.

The examination of the components of the debt stock growth of 1995-2005 reveals that the borrowing of the private sector played the leading part in the increase of both gross and net debt, representing 70% of the growth. In an open, converging economy the growth of the debt of the private sector is not to be considered "critical". The improvements implemented with the increased borrowing facilitated the dynamic growth of the Hungarian economy in excess of the EU average. The detailed analysis of the external debt between 1995 and 2005 is included in Annex 1.

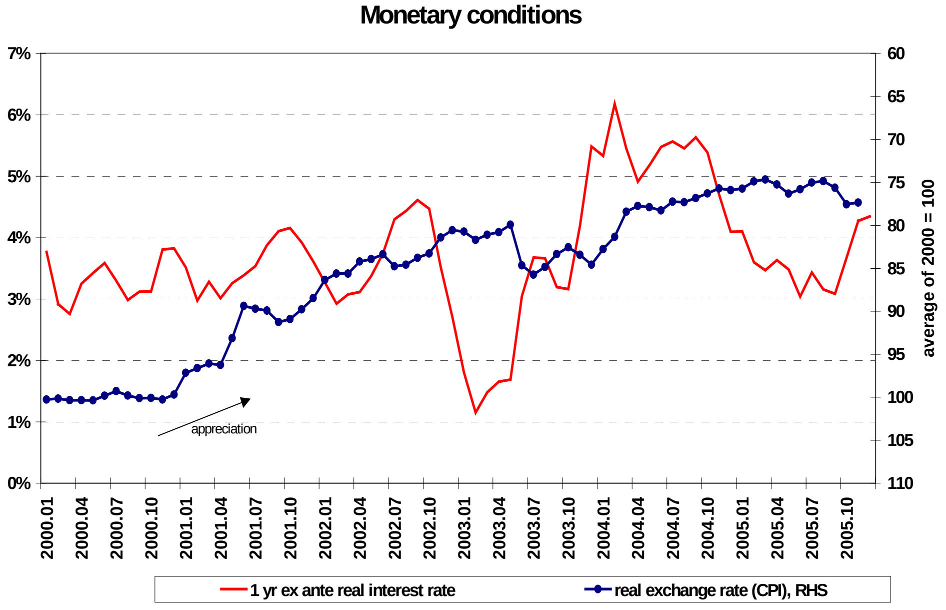
The examination of the Q1-Q3 balance of payments and of the January-November foreign trade statistics reveals that for the whole of 2005, a current account deficit of EUR 6.7-7 billion, or 7.6-8% of GDP, is to be expected, representing a decline of approx. 1%. In Q4, the improvement of the balance of the trade of goods and services neutralises the increase of the income from foreign capital investments. The financing requirement as a percentage of GDP is expected to be around 7-7.4%, similar to the first three quarters, which is well below the year 1999-2000 level of approx. 8%. In 2006, no improvement of the balance is to be expected in the trade of goods and services due to the expanding import requirement of the growing economy and investments. The higher income from foreign investments, which increases the current account deficit, is offset by the increment of revenues from EU institutions (net current EU transfers are expected to increase by EUR 200-300 million). Based on all that, the current account deficit (without the Grippen purchases) may be around the year 2005 level, or 100-200 million higher (EUR 6.9-7.2 billion), which corresponds to 7.5-7.8% of GDP. Through the EUR 200-300 million increase of EU capital transfers, the external financing requirement will continue to decline, to approx. 6.6-7.0% of GDP.

5. Monetary developments

5.1 Monetary conditions

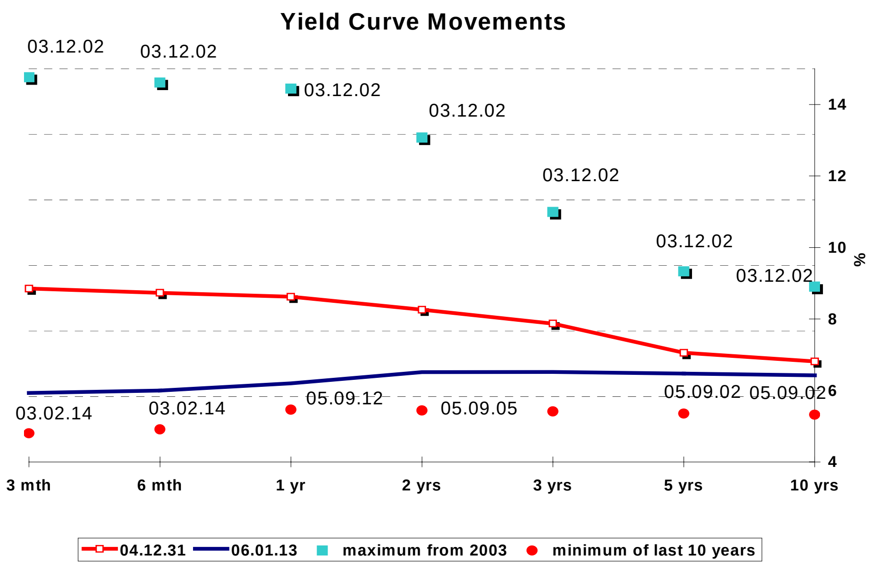
No substantive change in monetary conditions during 2005

In 2005, monetary conditions did not change substantially. Real interest rates moved within the usual 3-4% range, while the consumer price based real exchange rate depreciated marginally. The latter took place as a result of a 3% HUF/EUR nominal depreciation and an inflation differential much smaller than previously.



Last year, yields, particularly short-term, developed more favourably than that projected in the Convergence Programme of 2004. This was supported by the international environment as Euro yields were also lower than expected in 2005. The stability of Hungarian financial markets and that of asset prices is indicated by the fact that even though the budget deficit, a priority for investors, turned out higher than budgeted, yields declined on the whole and the exchange rate remained stable.

At its first eight rate setting meetings of 2005, the Monetary Council reduced the base rate in small steps, then, leaving the base rate at the same level first, left it unchanged until year-end. On the whole, in 2005 the base rate fell by 3.5 percentage points. This is the highest value recorded in the EU; even so, the Hungarian base rate is the highest in Union at present.



Conflicting factors continue to influence monetary policy. On the one hand, price stability, the primary objective of the central bank, is not endangered: the inflation projection of the NBH itself is considerably lower than before, the international investment environment is favourable, while on the other hand, the concerns relating to public finances and the uncertainty of investor confidence slow down the decline of the risk premium and of spreads.

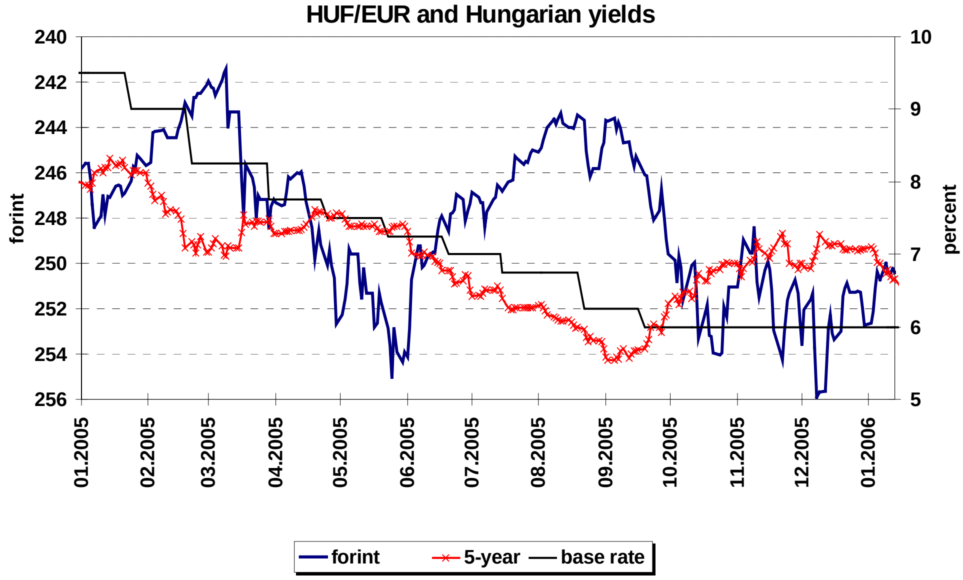
The changes (increase) of the ex ante real interest rate in recent months is hardly suitable for the accurate quantification of monetary conditions, as they are attributable not only to rising yields but also to the lowered inflationary expectations as a result of the one-off effect of the VAT rate cut.

5.2 Exchange rates

The exchange rate continues to be strong and stable

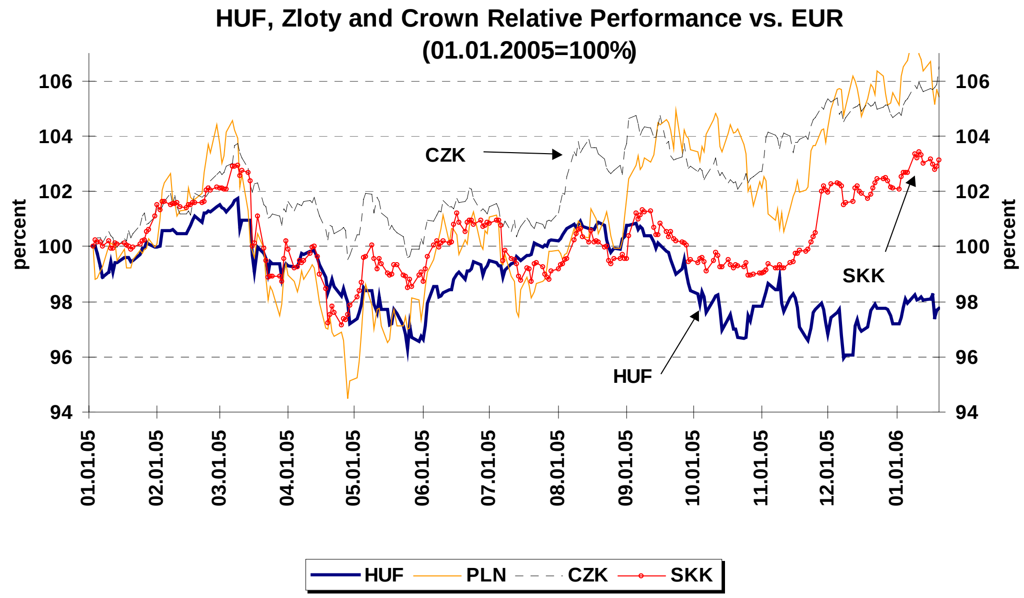
For more than one year, between early July 2004 and early October 2005, the exchange rate was typically stronger than the 250 HUF/EUR level, with the exception of May 2005. Since early October, the exchange rate has been only a few Forints weaker. For the entire year, the HUF/EUR exchange rate moved in a ±3% band. Last year the average annual exchange rate was 248 HUF/EUR, or 199.7 HUF/USD. The strong and stable exchange rate continued to greatly facilitate the lasting deceleration of inflation, the attainment of rates below the inflation target last year and the inflation rate for this year foreseeably being significantly better than the inflation target. These developments allowed the Government and the NBH to replace the annual inflation targets last year by a 3% medium-term inflation target for the 2007-2009 period, which is consistent with price stability in the converging Hungarian economy. The external financing requirement is fully satisfied by the foreign currency borrowing of households supplemented by the net FDI inflow, the Forint demand of the public sector and the foreign currency fund-raising of the corporate sector; Hungary's dependence on foreign portfolio capital inflow has fallen to nearly zero. Because of these factors, there is low probability of any major Forint depreciation in the short term. According to the analysts' expectations, disclosed in the latest Reuters poll of 15 December, the exchange rate will continue to be relatively strong by December 2006, though weaker than last year (around 256 HUF/EUR).

The relative stability of the exchange rate has created a favourable environment both for businesses and households. The level of the exchange rate and its movement within the year created a favourable background for the balanced development of the trade of goods and services and the narrowing of the deficit of the real balance. On the other hand, the net foreign currency borrowing position of households and of the business sector represented a higher factor of uncertainty due to the weakening of the Forint in the last third of the year and its greater volatility. The market value of the debts increased, but, given the current exchange rates, the revaluation losses have been offset by the interest savings realised.



For the whole of the year, the volatility of the HUF/EUR exchange rate was level with the volatility of the Czech and Slovak Crown and was smaller than the Zloty's. Nevertheless, while the movement of the Forint was not substantially different from the exchange rate trends of the Czech Crown, the Slovak Crown and the Zloty until early August, subsequently the other currencies followed a strengthening trend, while the Forint weakened. The movement of these currencies was dominated essentially by international events, the most important one being investors' expectations concerning dollar yields' developments; at times, however, domestic news also played an important role (Forint, Zloty). The fluctuations of the EUR/USD rate were reflected in the dollar exchange rates of these currencies.

The Forint moved parallel with the other currencies of the region, expect in the last third of the year



Budapest, 17 January 2006

Annex 1

External debt between 1995 and 2005

In the balance of payment statistics and debt service indicators, the NBH publishes three gross and net foreign debt figures, with different content:

1. **foreign currency debt:** debt denominated in foreign currencies;

2. **foreign debt (without other capital):** in addition to foreign currency debt, it also contains Forint denominated debt stock;

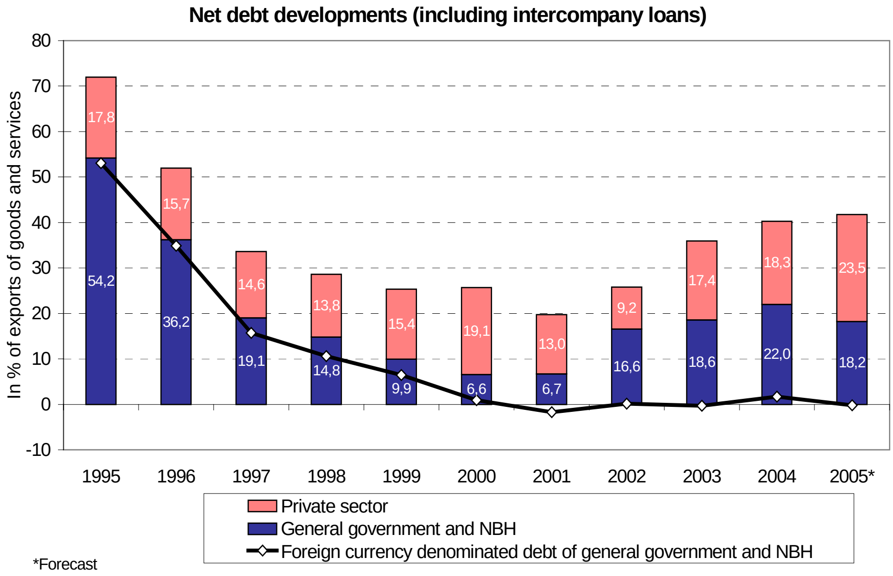
3. **foreign debt (with other capital):** in addition to foreign currency and Forint denominated stocks, it also includes the stock of other capital (inter-company loans).

The analysis covers the debt including Forint-denominated stocks (as per point 2), because inter-company loans constitute part of foreign direct investments and multinational companies (particularly since 2001) have appreciated these stocks annually by orders of magnitude (by EUR 0.5-1.5 billion), which should not be considered as a debt increase resulting from economic processes.

For the **assessment of** the **solvency** and **indebtedness** of a country, international entities (rating agencies, experts) **look at** the **net**, rather than gross, **debt**, as well as the debt servicing **burdens**, the gross interest payments. The assessment is based on the ratio of those indicators to other performance indicators of the economy (GDP as well as the exportation of goods and services), because these reflect the actual capacity of the economy for debt servicing.

In 1990, at the time of transition, net debt was almost double the exports (176%), the gross debt approximately two and a half times that figure (234%). By 1995, the net debt to export ratio fell to 72%, the gross ratio to 156%; as a percentage of GDP, net debt declined from 46% to 32%.

By end-2005, the total net debt is expected to have amounted to 42% of exports, i.e., the net indebtedness ratio of the country fell by 30 percentage points since 1995. Within that figure, the net foreign currency debt to exports ratio declined from 71% in 1995 to 23% in 2005. The aggregate net debt of the general government and of the National Bank of Hungary was reduced by 36 percentage points in ten years, while the net foreign currency debt, including privatisation proceeds, fell to zero. Thus the foreign exchange exposure of the general government consolidated with the National Bank of Hungary practically disappeared. During the same period, however, the net debt stock of the private sector increased from 18% to 22-24% of private exports. As a percentage of GDP, the net debt of the country went down by approx. 3 percentage points in the ten years under review; the debt of the general government and of the NBH fell by 12 percentage points, that of the private sector increased by 8 percentage points.



The data above indicate that the debt grew as a result of the external fund-raising of the private sector, which is a natural process in light of the significant FDI inflow (and within that, privatisation) of the period. These mostly foreign owned firms either raise direct investment or borrow abroad for their operation, which is covered by the export revenues of the companies. The difference of the Forint and foreign currency interest rates played a major part in the increase of the currency debt of the private sector (particularly in 2004-2005), which is also indicated by the difference of the calculated interest levels: the calculated interest rate of the general government and NBH gross debt between 1998 and 2005 was 5-8%, while for the private sector, it was half that figure (3-4%).

The ratio of the gross debt to exports declined by 62 percentage points as compared to 1995; within that, the debt of the general government and the NBH fell even more, by 75 percentage points, while that of the private sector increased by almost 13 percentage points. As a percentage of GDP, the gross debt at end-2005 is expected to have been almost 6 percentage points lower; within that, the debt of the general government and the NBH 23 percentage points lower, while the debt of the private sector will be 17 percentage points higher than in 1995.

Due to the rise of the central bank base rate at end-2003, the interest expenditures on the foreign debt of the general government increased, but this did not represent a growth over the 2002 levels in proportion to exports or GDP. The total gross interest expenditure continuously declined between 1999 and 2003 as a percentage of exports and GDP alike and, following a slight increase in 2004, is expected to have remained on the previous year's level in 2005.

It can be concluded that the main reason of the debt increase is the growing borrowing of the private sector, which also changed the structure of debt: in 1995, the gross and net debt of the private sector constituted 24% of the total foreign debt, while at the end of Q3 2005, it exceeded 50%.

Annex 1
Table 1

Foreign debt stock development of Hungary between 1995-2005

billion euro

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005 Q1-Q3	2005 expected MOF estimate
Stock of gross foreign debt (with inter-company loans)	**15,8**	**24,6**	**22,7**	**22,4**	**23,7**	**29,4**	**32,9**	**37,9**	**39,2**	**47,6**	**57,0**	**66,9**	**67,0**
of which: general government and NBH		*18,1*	*14,9*	*12,5*	*12,3*	*15,1*	*16,0*	*16,9*	*18,4*	*20,1*	*24,0*	*27,6*	*26,0*
private sector		*6,5*	*7,8*	*9,9*	*11,3*	*14,3*	*16,8*	*21,0*	*20,8*	*27,6*	*33,0*	*39,3*	*41,0*
Stock of gross foreign debt (without inter-company loans)	**15,8**	**23,8**	**21,2**	**20,4**	**21,2**	**26,0**	**29,2**	**32,1**	**32,3**	**38,8**	**47,3**	**55,8**	**55,9**
of which: general government and NBH		*18,1*	*14,9*	*12,5*	*12,3*	*15,1*	*16,0*	*16,9*	*18,4*	*20,1*	*24,0*	*27,6*	*26,0*
private sector		*5,7*	*6,3*	*7,9*	*8,9*	*10,9*	*13,2*	*15,2*	*13,9*	*18,7*	*23,3*	*28,2*	*29,9*
Gross foreign debt denominated in foreign currency	**15,8**	**23,7**	**20,9**	**19,4**	**19,8**	**23,7**	**25,7**	**26,4**	**22,8**	**26,9**	**31,3**	**38,6**	**38,8**
of which: general government and NBH		*17,9*	*14,6*	*11,8*	*11,3*	*13,3*	*13,0*	*12,1*	*10,5*	*11,1*	*12,9*	*16,4*	*14,6*
private sector		*5,7*	*6,3*	*7,7*	*8,6*	*10,4*	*12,7*	*14,3*	*12,4*	*15,8*	*18,4*	*22,2*	*24,2*
Stock of net foreign debt (with inter-company loans)	**11,8**	**11,8**	**10,6**	**9,3**	**9,8**	**10,5**	**13,2**	**13,8**	**16,2**	**21,4**	**26,8**	**31,2**	**31,4**
of which: general government and NBH		*8,3*	*6,3*	*4,2*	*3,8*	*2,9*	*2,5*	*2,9*	*7,4*	*8,6*	*11,7*	*12,3*	*10,8*
private sector		*3,5*	*4,2*	*5,1*	*5,9*	*7,7*	*10,7*	*10,9*	*8,8*	*12,9*	*15,0*	*18,9*	*20,6*
Stock of net foreign debt (without inter-company loans)	**11,8**	**11,0**	**9,1**	**7,5**	**7,4**	**7,3**	**9,7**	**8,4**	**11,5**	**16,6**	**21,5**	**24,8**	**24,7**
of which: general government and NBH		*8,3*	*6,3*	*4,2*	*3,8*	*2,9*	*2,5*	*2,9*	*7,4*	*8,6*	*11,7*	*12,3*	*10,8*
private sector		*2,7*	*2,7*	*3,2*	*3,6*	*4,5*	*7,2*	*5,5*	*4,1*	*8,0*	*9,8*	*12,5*	*13,9*
Net foreign debt denominated in foreign currency	**11,8**	**10,8**	**8,8**	**8,1**	**7,6**	**7,4**	**7,4**	**4,5**	**5,5**	**8,0**	**11,1**	**14,3**	**13,6**
of which: general government and NBH		*8,1*	*6,1*	*3,5*	*2,7*	*1,9*	*0,4*	*-0,7*	*0,1*	*-0,1*	*0,9*	*1,4*	*-0,1*
private sector		*2,7*	*2,7*	*4,6*	*4,9*	*5,5*	*7,0*	*5,2*	*5,4*	*8,2*	*10,2*	*12,9*	*13,7*
Interest ratios, in %													
Gross interest payment / stock of gross debt (with other capital)	**8,3**	**7,7**	**7,8**	**8,9**	**7,6**	**5,2**	**5,7**	**5,5**	**4,6**	**3,9**	**4,1**		**3,9**
of which: general government and NBH				*11,0*	*11,1*	*7,0*	*7,6*	*7,4*	*6,1*	*5,6*	*5,3*		*5,4*
private sector				*5,6*	*3,6*	*3,3*	*3,7*	*3,8*	*3,4*	*2,5*	*3,2*		*2,9*
Gross interest payment / stock of gross debt (without other capital)	**8,3**	**7,9**	**8,2**	**9,6**	**8,5**	**5,8**	**6,4**	**6,3**	**5,5**	**4,8**	**5,0**		**4,7**
of which: general government and NBH				*11,0*	*11,1*	*7,0*	*7,6*	*7,4*	*6,1*	*5,6*	*5,3*		*5,4*
private sector				*7,0*	*4,6*	*4,2*	*4,9*	*5,0*	*4,8*	*3,8*	*4,6*		*4,0*

Source: NBH Statistical Department

Annex 1
<u>Table 2</u>

Foreign debt stock development of Hungary between 1995-2005

in % of GDP

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005*/ Q1-Q3	2005 expected MOF estimate
Stock of gross foreign debt (with inter-company loans)	**60,7**	**71,4**	**62,9**	**55,4**	**56,5**	**65,2**	**64,9**	**65,6**	**56,2**	**64,7**	**70,3**	**76,0**	**76,1**
of which: general government and NBH		*52,5*	*41,2*	*30,9*	*29,5*	*33,6*	*31,6*	*29,3*	*26,4*	*27,3*	*29,6*	*31,4*	*29,6*
private sector		*18,9*	*21,6*	*24,5*	*27,0*	*31,6*	*33,2*	*36,3*	*29,8*	*37,5*	*40,7*	*44,7*	*46,5*
Stock of gross foreign debt (without inter-company loans)	**60,7**	**69,0**	**58,7**	**50,4**	**50,7**	**57,7**	**57,6**	**55,5**	**46,4**	**52,7**	**58,3**	**63,4**	**63,5**
of which: general government and NBH		*52,5*	*41,2*	*30,9*	*29,5*	*33,6*	*31,6*	*29,3*	*26,4*	*27,3*	*29,6*	*31,4*	*29,6*
private sector		*16,6*	*17,5*	*19,5*	*21,2*	*24,1*	*26,0*	*26,2*	*20,0*	*25,5*	*28,8*	*32,1*	*33,9*
Gross foreign debt denominated in foreign currency	**60,7**	**68,5**	**58,0**	**47,9**	**47,3**	**52,7**	**50,7**	**45,6**	**32,8**	**36,6**	**38,7**	**43,8**	**44,1**
of which: general government and NBH		*52,0*	*40,6*	*29,0*	*26,9*	*29,5*	*25,7*	*20,9*	*15,0*	*15,2*	*16,0*	*18,6*	*16,6*
private sector		*16,6*	*17,5*	*18,9*	*20,5*	*23,2*	*25,0*	*24,7*	*17,7*	*21,4*	*22,7*	*25,2*	*27,5*
Stock of net foreign debt (with inter-company loans)	**45,5**	**34,1**	**29,3**	**23,1**	**23,3**	**23,4**	**26,0**	**23,9**	**23,2**	**29,1**	**33,0**	**35,5**	**35,6**
of which: general government and NBH		*23,9*	*17,5*	*10,5*	*9,2*	*6,4*	*4,9*	*5,0*	*10,6*	*11,6*	*14,5*	*14,0*	*12,3*
private sector		*10,2*	*11,8*	*12,6*	*14,2*	*17,0*	*21,1*	*18,9*	*12,6*	*17,5*	*18,5*	*21,5*	*23,4*
Stock of net foreign debt (without inter-company loans)	**45,5**	**31,8**	**25,1**	**18,5**	**17,7**	**16,3**	**19,1**	**14,5**	**16,5**	**22,5**	**26,5**	**28,2**	**28,1**
of which: general government and NBH		*23,9*	*17,5*	*10,5*	*9,2*	*6,4*	*4,9*	*5,0*	*10,6*	*11,6*	*14,5*	*14,0*	*12,3*
private sector		*7,9*	*7,6*	*8,0*	*8,5*	*9,9*	*14,2*	*9,6*	*5,9*	*10,9*	*12,0*	*14,2*	*15,8*
Net foreign debt denominated in foreign currency	**45,5**	**31,3**	**24,5**	**20,0**	**18,2**	**16,4**	**14,6**	**7,8**	**7,8**	**10,9**	**13,7**	**16,2**	**15,5**
of which: general government and NBH		*23,4*	*16,9*	*8,6*	*6,6*	*4,2*	*0,7*	*-1,3*	*0,1*	*-0,2*	*1,1*	*1,6*	*-0,1*
private sector		*7,9*	*7,6*	*11,4*	*11,6*	*12,2*	*13,9*	*9,0*	*7,7*	*11,1*	*12,6*	*14,7*	*15,6*
Gross interest payment	**5,0**	**5,4**	**5,1**	**4,9**	**4,2**	**3,1**	**3,5**	**3,3**	**2,6**	**2,3**	**2,6**		**2,7**
of which: general government and NBH				*3,7*	*3,3*	*2,1*	*2,3*	*2,1*	*1,5*	*1,5*	*1,4*		*1,5*
Net interest payment	**4,3**	**3,5**	**2,6**	**2,1**	**2,0**	**1,6**	**1,6**	**1,3**	**1,1**	**1,1**	**1,7**		**1,7**
of which: general government and NBH				*1,9*	*1,6*	*1,2*	*1,2*	*0,9*	*0,8*	*0,8*	*1,0*		*1,0*

***/ in % of the expected GDP for 2005**
Source: NBH Statistical Department

Annex 1
<u>Table 3</u>

Foreign debt stock development of Hungary between 1995-2005

in % of the goods and services export

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005*/ Q1-Q3	2005 expected MOF estimate
Stock of gross foreign debt (with inter-company loans)	**234,4**	**161,5**	**130,1**	**100,9**	**91,5**	**101,5**	**87,2**	**89,1**	**87,7**	**103,4**	**106,8**	**113,1**	**113,2**
of which: general government and NBH		*118,8*	*85,3*	*56,2*	*47,7*	*52,2*	*42,5*	*39,8*	*41,2*	*43,6*	*44,9*	*46,7*	*44,0*
private sector		*42,8*	*44,8*	*44,7*	*43,8*	*49,2*	*44,7*	*49,3*	*46,6*	*59,9*	*61,8*	*66,4*	*69,2*
Stock of gross foreign debt (without inter-company loans)	**234,4**	**156,2**	**121,5**	**91,8**	**82,0**	**89,8**	**77,4**	**75,4**	**72,4**	**84,3**	**88,6**	**94,3**	**94,4**
of which: general government and NBH		*118,8*	*85,3*	*56,2*	*47,7*	*52,2*	*42,5*	*39,8*	*41,2*	*43,6*	*44,9*	*46,7*	*44,0*
private sector		*37,5*	*36,2*	*35,5*	*34,2*	*37,5*	*34,9*	*35,6*	*31,2*	*40,7*	*43,7*	*47,7*	*50,5*
Gross foreign debt denominated in foreign currency	**234,4**	**155,1**	**120,1**	**87,3**	**76,6**	**81,9**	**68,0**	**62,0**	**51,1**	**58,5**	**58,7**	**65,2**	**65,6**
of which: general government and NBH		*117,6*	*84,0*	*52,9*	*43,5*	*45,9*	*34,5*	*28,4*	*23,5*	*24,2*	*24,3*	*27,7*	*24,6*
private sector		*37,5*	*36,2*	*34,4*	*33,1*	*36,1*	*33,6*	*33,6*	*27,7*	*34,3*	*34,5*	*37,5*	*41,0*
Stock of net foreign debt (with inter-company loans)	**175,6**	**77,3**	**60,6**	**42,0**	**37,7**	**36,4**	**34,9**	**32,5**	**36,2**	**46,5**	**50,1**	**52,7**	**53,0**
of which: general government and NBH		*54,2*	*36,2*	*19,1*	*14,8*	*9,9*	*6,6*	*6,7*	*16,6*	*18,6*	*22,0*	*20,8*	*18,2*
private sector		*23,1*	*24,4*	*23,0*	*22,9*	*26,5*	*28,3*	*25,7*	*19,7*	*27,9*	*28,1*	*32,0*	*34,8*
Stock of net foreign debt (without inter-company loans)	**175,6**	**72,0**	**51,9**	**33,6**	**28,6**	**25,4**	**25,7**	**19,7**	**25,8**	**36,0**	**40,3**	**41,9**	**41,8**
of which: general government and NBH		*54,2*	*36,2*	*19,1*	*14,8*	*9,9*	*6,6*	*6,7*	*16,6*	*18,6*	*22,0*	*20,8*	*18,2*
private sector		*17,8*	*15,7*	*14,6*	*13,8*	*15,4*	*19,1*	*13,0*	*9,2*	*17,4*	*18,3*	*21,1*	*23,5*
Net foreign debt denominated in foreign currency	**175,6**	**70,8**	**50,6**	**36,5**	**29,4**	**25,5**	**19,6**	**10,6**	**12,2**	**17,4**	**20,8**	**24,2**	**23,0**
of which: general government and NBH		*53,1*	*34,9*	*15,7*	*10,6*	*6,5*	*0,9*	*-1,7*	*0,2*	*-0,3*	*1,7*	*2,3*	*-0,2*
private sector		*17,8*	*15,7*	*20,8*	*18,8*	*19,0*	*18,6*	*12,3*	*12,1*	*17,7*	*19,1*	*21,8*	*23,2*
Gross interest payment	**19,3**	**12,1**	**10,6**	**9,0**	**6,8**	**4,8**	**4,7**	**4,5**	**4,0**	**3,7**	**4,0**		**4,1**
of which: general government and NBH				*6,8*	*5,3*	*3,3*	*3,1*	*2,9*	*2,4*	*2,3*	*2,2*		*2,3*
Net interest payment	**16,6**	**8,0**	**5,4**	**3,8**	**3,2**	**2,4**	**2,2**	**1,8**	**1,7**	**1,8**	**2,6**		**2,6**
of which: general government and NBH				*3,4*	*2,5*	*1,8*	*1,6*	*1,2*	*1,2*	*1,3*	*1,6*		*1,5*

***/ in % of the expected goods and services export for 2005**
Source: NBH Statistical Department

Annex 2

Public debt developments in the 1995-2005 period

In most modern economies, the expenditures of general governments exceed their revenues. The part of expenditures in excess of revenues is covered by government debt towards other sectors (households, businesses, external). The changes of the debt stock are affected by the **cumulative balance of the general government** as well as other factors (e.g. privatisation proceeds) and the so-called **re-valuation effects**, most of which relate to exchange rate changes.

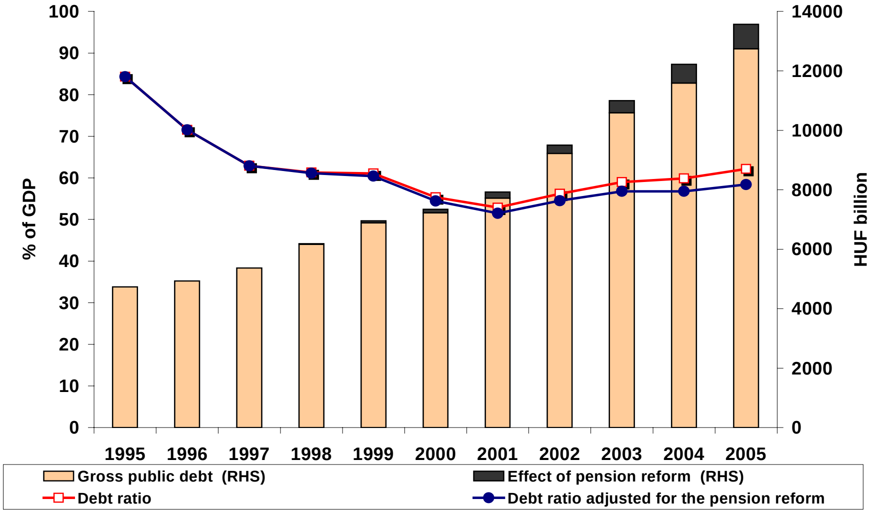
We can look at the general government debt from **several aspects**. It can be examined through the **breakdown** of the general government **organization** (general government, subsystems), by **currencies** (domestic, foreign), **type of debt instruments** (securities, loans, marketable, non-marketable), **the place of establishment of the creditors** (resident, non-resident), the **carrying value** (nominal value, market value) or various **economic classifications** (cash basis, Maastricht debt). The debt classified by various criteria is mostly expressed by two indicators. One is the absolute value of the debt in the national currency, the other one is the percentage of the debt to GDP (debt ratio). Of the two indicators, the latter is more appropriate to illustrate real economic relations and to show the determining effects of debt on the growth potential of the economy.

In line with the Act on Public Finances, the most frequently published and most well-known form of the Hungarian public debt statistics is the central government gross debt compiled according to Hungarian accounting standards. Apart from the fact that within general government, in contains only the debt of the central government, the social security funds and the extra-budgetary funds, its most outstanding feature is that it is recorded at nominal value[*]. The debt changes mainly at the date of cash movements (borrowing, redemption, other items). Furthermore, the revaluation caused by exchange rate changes is incorporated into the value of debt, and thus also into its change.

Producing a growth of some 170% in the past 10 years, the **gross debt of the central government** increased to HUF 12 744 billion by the end of 2005. The significant increase in absolute terms resulted in a **decline as a percentage of the economic output (GDP), to roughly two thirds of the previous level (from 84.3% to 58.4%).** The approx. 26 percentage point fall in the debt ratio resulted from the growth of nominal GDP significantly exceeding debt growth. The processes of the past 10 years were not gradual or completely even. An over 20-percentage-point drop in the debt ratio occurred already by 1998. In the subsequent three years (1999-2001), another 10-percentage-point decline occurred, then the trend was reversed, and in the past four years the debt ratio climbed by some 7 percentage points.

[*] Treasury bills are recorded at their issue price.

Gross debt of central government



One of the most important statistical indicators in the economic statistics of the European Union and in the assessment of economic developments is the **public (Maastricht) debt** of the various countries. The Maastricht debt differs from the previously discussed indicator in the valuation of the debt, the incorporation of accrued interest and in particular in the scope of institutions covered. The Maastricht debt includes the central government as well as the local governments and the debts of enterprises under dominant state control and responsibility, while, through consolidation, it eliminates the debts of the sub-systems vis-à-vis each other.

In the past ten years, the Maastricht debt followed a course similar to the debt of the central budget, even though the rate of the change was slightly more favourable both in absolute terms and as regards the debt ratio.

For the calculation of both debt ratios, the Hungarian statistical authorities in the temporary period adjust the figures for the stock of **government securities accumulated in the private pension funds**. The adjustment is partly for economic reasons, because the amounts mandatorily remitted into private pension funds, then invested in government securities, represent long-term savings, and cause no demand growth in the short-to-medium term, and on the other hand, they facilitate international comparisons on the same platform. Since the introduction of the multi-pillar pension fund system, the government securities in the portfolio of private pension funds have been increasing gradually, reaching approx. 4% of GDP at the end of 2005.

TABLES

Table 1.

Economic indicator (cumulative data, from the beginning of the year)

1. Real sector, Prices, Competitiveness

percentage change, compared to the same period of previous year

	2001	2002	2003	2004				2005											
				I quarter	I. half of year	I-III. quarter	I-IV. quarter	1. month	1-2. month	I. quarter	1-4. month	1-5. month	I. half of year	1-7. month	1-8. month	I-III. quarter	1-10. month	1-11. month	I-IV. quarter
GDP volume	4.3	3.8	3.4	4.9	4.9	4.7	4.6	-	-	3.2	-	-	3.9	-	-	4.1	-	-	-
Household consumption	5.8	9.7	7.8	2.5	3.4	3.6	3.1	-	-	1.8	-	-	2.2	-	-	2.3	-	-	-
Government consumption	1.2	6.6	7.9	2.9	2.4	2.2	0.9	-	-	-1.3	-	-	-1.4	-	-	-1.5	-	-	-
Gross fixed capital formation	5.9	9.3	2.5	19.0	13.6	13.2	8.4	-	-	6.8	-	-	8.3	-	-	8.5	-	-	-
Domestic use	2.4	5.9	6.2	1.3	3.2	3.1	2.8	-	-	1.3	-	-	-0.3	-	-	0.3	-	-	-
Export of goods and services	8.0	3.9	7.8	19.5	20.2	18.0	16.4	-	-	6.4	-	-	8.9	-	-	9.8	-	-	-
Imports of goods and services	5.2	6.6	11.1	13.7	16.8	15.0	13.2	-	-	4.2	-	-	4.0	-	-	5.2	-	-	-
Volume of investment	3.5	7.8	2.2	18.9	13.5	13.2	7.8	-	-	6.8	-	-	8.3	-	-	8.5	-	-	-
Volume of industrial production	3.6	2.8	6.4	9.9	9.8	8.2	7.4	3.6	2.2	2.0	3.9	5.8	5.9	5.9	6.7	6.9	7.2	7.3	-
Volume of construction	8.3	17.8	2.0	15.4	7.2	5.9	5.8	9.5	15.4	9.8	11.3	10.5	13.8	14.6	14.4	17.4	16.9	-	-
Foreign trade turnover: export volume	7.8	6.8	9.1	20.1	21.3	19.7	18.4	8.1	7.1	6.7	9.4	9.9	9.7	8.9	9.8	10.1	9.7	-	-
import volume	4.0	6.1	10.1	16.1	19.2	17.1	15.2	8.4	6.1	3.5	2.7	2.9	2.9	2.9	4.0	4.2	4.2	-	-
Volume of retail trade turnover 9/	5.4	10.7	8.4	5.2	7.4	6.4	5.6	1.8	1.5	2.9	2.1	2.7	3.6	3.5	3.9	4.1	4.3	-	-
Number of employees (in thousands) 1/ -household survey	3,868.3	3,870.6	3,921.9	3,891.5	3,892.8	3,897.4	3,900.4	3,864.3	3,864.3	3,870.6	3,872.3	3,877.3	3881.1	3888.1	3892.2	3896.6	3901.4	3902.4	-
-labour statistics	2,722.0	2,726.3	2,753.0	2,768.9	2,784.8	2,791.5	2,789.6	2,774.8	2,773.8	2,773.4	2,776.5	2,780.4	2783.8	2786.0	2786.9	2788.4	2789.1	-	-
Vacancies (in thousands) 2/	37.3	34.0	44.0	48.6	53.0	51.8	48.2	34.1	35.7	35.9	38.3	39.9	40.8	41.3	41.5	42.2	42.4	42.0	-
Number of unemployed (in thousands) 2/	342.8	344.9	359.9	395.5	379.5	373.8	376.0	430.3	434.8	435.3	431.3	424.9	418.8	415.9	413.9	412.6	410.9	409.9	-
Rate of unemployment (household survey, %)	5.7	5.8	5.9	6.1	6.0	6.0	6.1	7.2	7.1	7.1	7.2	7.2	7.1	7.1	7.2	7.2	7.2	7.2	-
Consumer price index	9.2	5.3	4.7	6.8	7.1	7.0	6.8	4.1	3.6	3.6	3.7	3.6	3.7	3.7	3.7	3.7	3.6	3.6	-
Index of industrial domestic sale prices	9.4	1.6	5.0	7.2	8.2	8.5	8.4	10.6	10.3	10.2	10.2	9.9	9.7	9.5	9.2	9.0	8.8	8.6	-
Index of industrial export sale prices	1.5	-4.5	0.3	2.1	1.3	0.2	-0.4	-1.3	-1.6	-0.7	-0.1	0.5	0.7	0.8	0.8	0.8	1.0	1.1	-
Agricultural production prices	4.9	-1.1	5.3	14.5	14.7	3.4	-5.4	-13.3	-13.8	-12.9	-11.9	-11.5	-10.5	-6.2	-5.5	-5.5	-3.3	-0.4	-
Competitiveness 8/:																			
based on CPI	-7.7	-9.1	-1.4	-0.4	-2.6	-4.7	-5.8	-8.5	-8.2	-7.1	-6.1	-5.3	-5.0	-4.7	-4.5	-4.2	-3.6	-3.1	-
based on manufacturing prices	-9.1	-7.9	-0.9	0.6	-2.1	-4.5	-5.8	-8.6	-8.8	-7.7	-6.6	-5.7	-5.1	-4.6	-4.2	-3.8	-3.3	-	-
based on ULC (value added)	-7.4	-10.0	2.6	4.5	1.8	-1.9	-3.7	-	-	-7.7	-	-	-3.2	-	-	-	-	-	-

Table 2.

Economic indicator (cumulative data, from the beginning of the year)

2. Income and Monetary Aggregates

percentage change, compared to the same period of previous year

	2001	2002	2003	2004				2005											
				I quarter	I. half of year	I-III. quarter	I-IV. quarter	1. month	1-2. month	I. quarter	1-4. month	1-5. month	I. half of year	1-7. month	1-8. month	I-III. quarter	1-10. month	1-11. month	I-IV. quarter
Average earnings : gross	18.0	18.3	12.0	9.2	8.5	7.9	6.0	26.2	17.5	13.7	11.9	11.5	10.9	10.4	10.0	9.7	9.4	-	-
net	16.2	19.6	14.3	8.0	7.5	7.0	5.6	23.2	16.5	13.7	12.3	12.1	11.6	11.2	10.9	10.7	10.5	-	-
Household: savings (HUF billion)	1,605.8	1,656.7	1,542.9	282.4	673.3	1,074.6	2,000.2	-	-	537.4	-	-	995.1	-	-	1,521.5	-	-	-
credits (HUF billion)	429.3	827.4	1,196.7	51.0	422.8	645.5	1,002.4	-	-	36.2	-	-	327.2	-	-	598.4	-	-	-
General government GFS balance (HUF billion) 3/	-444.0	-1,685.6	-1,103.5	-434.7	-1,040.2	-1,284.1	-1,327.9	-198.4	-393.9	-484.9	-710.0	-837.7	-988.1	-936.4	-996.4	-1,059.5	-1,061.6	-1,197.1	-984.4
Central budget GFS balance (HUF billion)	-402.9	-1,469.6	-732.4	-364.9	-855.8	-1,035.8	-904.5	-199.1	-379.0	-373.1	-589.0	-680.5	-798.6	-741.3	-769.0	-780.9	-738.7	-744.7	-545.0
primary balance (HUF billion)	212.9	-832.0	-4.1	-186.3	-398.0	-412.8	-103.0	-167.7	-217.4	-189.9	-288.5	-338.4	-341.5	-267.4	-224.4	-216.9	-61.1	-4.3	253.7
revenue change	10.5	7.1	13.3	8.1	5.6	4.9	8.0	26.7	19.6	22.3	10.6	11.1	15.6	16.5	18.3	16.9	16.8	15.3	21.1
expenditure change	10.4	30.3	-2.7	17.3	19.4	15.4	10.0	23.2	27.6	17.6	16.2	15.7	9.6	9.3	10.4	7.6	7.6	7.6	12.3
Social Security Funds 4/: balance	-28.8	-100.9	-349.0	-91.3	-208.2	-284.5	-423.9	-9.8	-38.4	-136.9	-153.9	-186.0	-220.6	-240.3	-271.9	-320.7	-372.1	-502.2	-469.8
revenue change	18.6	17.2	4.6	8.5	9.5	10.1	7.9	24.1	26.8	11.1	15.9	17.7	11.8	13.4	14.6	10.6	10.9	11.5	11.0
expenditure change	14.9	20.4	14.2	9.2	11.1	10.2	9.6	2.1	6.6	15.7	14.4	10.7	11.1	11.2	11.1	10.9	10.8	11.3	10.9
Government paper benchmark yields (average annual) 5/																			
3 month	9.8	8.2	12.0	12.1	11.5	11.0	9.1	8.8	8.2	7.3	7.4	7.3	6.9	6.5	6.1	5.7	6.0	6.1	6.0
12 month	9.2	8.0	11.7	11.2	11.1	10.8	8.7	8.5	7.5	7.2	7.4	7.4	6.9	6.4	5.9	5.6	6.1	6.4	6.4
3 year-bonds	8.2	7.4	10.2	10.4	10.6	10.4	8.5	8.1	7.9	7.2	7.5	7.4	6.6	6.2	5.9	5.6	6.4	6.9	7.0
5 year-bonds	7.7	7.0	9.3	9.3	9.4	9.5	7.9	8.2	7.2	7.4	7.2	7.2	6.9	6.4	6.1	5.8	6.8	6.9	6.9
10 year-bonds	7.1	6.5	8.0	8.2	8.5	8.6	7.1	7.4	6.6	7.1	6.8	7.0	6.7	6.3	6.0	5.8	6.8	6.8	7.0
15 year-bonds	6.7	-	-	-	-	8.3	-	6.8	-	6.7	6.9	-	6.4	-	5.8	-	6.4	-	6.8
Interest rates 5, 6/:		-	-																
with maturity less than a year: credit	11.2	9.7	13.4	13.5	13.3	12.9	11.0	10.4	9.9	9.3	9.0	8.6	8.5	8.3	8.0	7.8	7.7	7.5	-
deposit	8.4	7.4	11.0	11.2	10.6	10.3	9.1	8.6	8.0	7.4	7.0	6.5	6.3	6.2	5.8	5.5	5.3	5.3	-
with maturity more than a year: credit	11.2	9.7	13.0	13.5	12.2	12.9	11.2	10.5	11.0	10.4	10.3	10.7	9.6	10.8	9.6	8.6	9.3	9.4	-
deposit	7.7	8.0	10.8	8.0	10.7	10.0	8.3	7.5	7.0	5.2	6.7	5.2	6.1	6.0	5.0	4.7	5.0	5.8	-
Balance of current account (EUR million)	-3,577	-4,929	-6,382	-1,324	-3,573	-5,339	-7,136	-	-	-1,545	-	-	-3,357	-	-	-5,054	-	-	-
External financing need (EUR million)	-3,219	-4,727	-6,414	-1,378	-3,625	-5,214	-6,876	-	-	-1,374	-	-	-3,003	-	-	-4,625	-	-	-
Non debt creating financing (EUR million)	2,303	2,670	-11	780	645	2,032	3,278	-	-	121	-	-	-1,272	-	-	680	-	-	-
Foriegn direct investment inflows (millió EUR)	4,391	3,185	1,887	764	742	2,089	3,236	-	-	1,043	-	-	2,335	-	-	2,825	-	-	-
Net foreign debt (EUR million) 7/	8.4	11.5	16.6	17.3	19.2	20.3	21.5	-	-	21.9	-	-	24.0	-	-	24.8	-	-	-
BUX index 2/	7,122	7,739	9,627	10,992	11,537	12,647	14,743	15,553	18,383	17,108	16,378	16,908	18,741	20,723	21,573	22,949	20,526	21,174	20,785

METHODOLOGICAL REMARKS

for Table 1 and 2

Signs: * Preliminary data; **.** : data is not available yet; **-** : no data for the period

1/ Data for firms with more than 5 employees and for budgetary institutions total.
2/ End of period data.
3/ Excluding privatization receipts and contributions paid into the compulsory funded pension funds.
At the general government the interim data do not include the local governments.
4/ Total revenues and expenditures of the Pension Fund and Health Fund are not consolidated
with the non-self-provided services.
5/ The yield or interest in the last month of the period.
6/ At deposits with maturity longer than a month but not longer than a year.
7/ Excluding intercompany loans
8/ Price based indicators seasonally non-adjusted, unit labour cost based indicators seasonally adjusted
9/ Including sales of motor vehicles and antomative fuel